Roll No..............................

Total No. of Questions—8]

Time Allowed—3 Hours | Maximum Marks—100

Auditing and Assurance (May, 2010)

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi medium. If a candidate who has not opted for Hindi medium, answers in Hindi, his answers in Hindi will not be valued.

Answer **all** questions.

Marks

1. State with reasons (in short) whether the following statements are True or False : 10×2 =20

   (i) While conducting audit of Government Companies, the auditors are paid their Professional Fees as prescribed by the Government.

   (ii) The auditor compares entries in the books of accounts with vouchers and if two agrees, his work is done.

   (iii) Confirmations received by the auditor directly from third parties are conclusive evidence in support of a transaction.

   (iv) Audit Committee is to be formed by each and every company and the auditor has no compulsion to attend the meeting of the Audit Committee.

   (v) A company can not declare dividends without providing for depreciation.

   (vi) When an auditor identifies a Misstatement resulting from fraud, it is his responsibility to communicate it to the regulatory and enforcement authorities apart from those charged with governance.

   (vii) The auditor should study the Memorandum and Articles of Association to see the validity of his appointment.

   (viii) A special resolution is required by company to authorise issue of shares at discount.

Marks

(ix) The Investments made by the company in Government Securities like NSC, Government Bonds, etc. should be kept in personal custody of Financial Controller of the Company.

(x) The company in which 15% of subscribed capital is held by State Financial Corporation and 10% of Subscribed capital is held by General Insurance Co., the appointment of auditor can be done by passing a general resolution at annual general meeting.

2. Comment on the following situations :

(a) Mr. Y was appointed as an auditor of PQR Ltd. for the year ended 31.3.2009 at Annual General Meeting held on 16.08.2008. Mr. Y has been indebted to the company for sum of Rs. 10,000 as on 1.4.2008, the opening date of accounting year which has been subject to his audit. However, Mr. Y having come to know that he might be appointed as auditor, he repaid the amount on 10.8.2008. One of the shareholders, complains that the appointment of Mr. Y as an auditor was invalid because he incurred disqualification u/s 226 of the Companies Act, 1956. 6

(b) XYZ (Pvt.) Ltd. has paid up Capital and Reserves of Rs. 60 lacs and secured Loans of Nationalised Banks having sanctioned limit of Rs. 28 lacs and outstanding balance of Rs. 23 lacs. The turnover of the company is 5.10 crores for the year ended 31.3.2009. A customer returns goods worth 40 lacs on 2.4.2009, out of sales made during the year ended 31.3.2009. The management of CO. is of the opinion that CARO, 2003 is not applicable to the company. 6

(c) C Ltd. declared dividend amounting to Rs. 5 lacs out of Profits for the year ended 31.3.2009. 8

Subsequently, it was noticed that company had failed to make provisions for Outstanding expanses of Rs. 7.80 lacs and Closing stock was also over valued, which was not reported by auditors of the company. Management of C Ltd. helds auditors responsible for this situation.

3. A trader is worried that inspite of substantial increase in sales compared to earlier year, there is considerable fall in Gross Profit after satisfying himself that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants to ensure that purchases have been truthfully recorded. 10

How will you proceed with this assignment ?

Marks

4. (a) Discuss Internal Controls in a CIS Environment. 5

   (b) Differentiate between 'Qualified report' and 'Adverse report'. 5

5. (a) Draft an audit programme for conducting audit of accounts of a Local Body. 5

   (b) 'The extent of audit procedure performed on corresponding figure is less compared to audit of current period figures', reporting. Justify the statement with regard to auditor's duties for reporting of comparatives under AAS 25. 5

6. (a) 'Doing the audit in EDP environment is simpler since Trial Balance always tallies.' 5

   Analyse the statement critically.

   (b) 'A Joint Auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report.' 5

   Justify this statement in the light of responsibilities of Joint Auditors under AAS 12.

7. How would you vouch/verify the following ? 5×2=10

   (a) Reduction in Share Capital

   (b) Receipt of Capital subsidy.

8. Write short notes on the following : 5×2=10

   (a) Substantive Procedures

   (b) Audit Working Papers.

Roll No. ....

Total No. of Questions – **7**

Time Allowed : **3** Hours | Maximum Marks : **100**

Auditing and Assurance (November, 2010)

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi medium, his answers in Hindi will not be valued.

Question No. **1** is compulsory.

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

Marks

1. Comment as a auditor on the following situations : –

   (a) Mr. X, a partner in X & Co., a firm of a Chartered Accountants, died on 31-3-2010 after completing routine audit work of XYZ Company Ltd.. Mr. Y another partner of the firm of Chartered Accountants signed the financial statements of XYZ Company Ltd., without reviewing the finalization work done by the assistants. **5**

   (b) 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. **5**

   (c) M.N.P. Company Ltd. purchased a machinery for ₹ 1.00 crore. The State Government granted the company a subsidy of ₹ 40 lakhs to meet partial cost of machinery. The company credited the subsidy received from the State Government to its Profit and Loss Account for the year ended March 31, 2010. **5**

Marks

(d) 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. **5**

2. (a) Explain briefly the technique of "Internal Control Questionnaire" to facilitate the accumulation of information necessary for proper evaluation of internal control. **4**

(b) State clearly the circumstances where "Auditing through the computer" approach must be used. **6**

(c) What do you mean by the term 'Sufficient Appropriate Audit Evidence' ? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence. **6**

3. (a) "The auditor is faced with sampling risk in both tests of control and substantive procedures." **8**

Comment on this statement with reference to SA 530 on "Audit Sampling".

(b) What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures ? Explain with reference to SA-520 on "Analytical procedures". **8**

4. Write short notes on any **four** of the following : **4x4 =16**

(a) Reliability of external confirmations.

(b) Physical verification of fixed assets "at reasonable intervals".

Marks

(c) Verification of credit sales.

(d) Factors governing modes of communication of auditor with those charged with governance.

(e) Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption.

5. (a) Mention briefly important points which an auditor will consider while conducting the audit of a club. 8

(b) What important points should an auditor keep in mind while checking receipt of income of a Non-Governmental Organization (N.G.O.) ? 4

(c) State briefly the circumstances when an auditor issues a disclaimer of opinion. 4

6. (a) Comment on the following :

X Ltd. has its Registered Office at Mumbai. During the current accounting year it shifted its Corporate Office to Delhi. The Managing Director of the Company wants to shift company's books of account to Delhi because he holds the view that there is no legal bar in doing so. 4

(b) A partnership firm revalued its fixed assets like land and building. The firm adequately disclosed the revalued amounts in the Balance Sheet. 4
Do you, as an auditor, approve the disclosure given by the partnership firm ?

(c) R.K. & Company are the auditors of PQR Company Ltd. The Managing Director of the Company demands copies of the working papers from the auditors. Are the auditors bound to oblige the Managing Director ? 4

			Marks
	(d)	"Responsibility for properly determining the quantity and value of inventory rests with the management." Comment on this statement.	4
7.	(a)	What points shall an auditor keep in mind while auditing an account of Bought Ledger having a debit balance ?	4
	(b)	PQR Company Ltd. removed their first auditor by passing a resolution in the meeting of the Board of Directors for his removal without obtaining prior approval from the Central Government. Offer your comments in this regard.	4
	(c)	R & M Company, a firm of Chartered Accountants, was appointed as statutory auditors of XYZ Company Ltd. Draft an engagement letter accepting the appointment as auditors.	8

Roll No. ....

Total No. of Questions – **7**

Time Allowed – **3** Hours | Maximum Marks – **100**

Auditing and Assurance (May, 2011)

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi medium, his answers in Hindi will not be valued.

Question No. **1** is compulsory.

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

Marks

1. Comment on the following in relation to SAs :

(a) "The work performed by each assistant needs to be reviewed by personnel of at least equal competence." **5**

(b) "Audit documentation serves a number of additional purposes." **5**

(c) "Management is responsible for compliance with laws and regulations." **5**

(d) "Auditor shall establish an overall strategy that sets the scope, timing and directions of the audit, and that guides the development of the audit plan." **5**

2. (a) Explain various methods to obtain audit evidence. **8**

(b) List out some examples of fraud that can be done by ledger keeper in Bought ledger and Sales ledger. **8**

		Marks
3.	(a) Discuss limitations of audit.	8
	(b) Discuss prerequisites and fundamental principles to be possessed by an auditor.	8
4.	(a) Give various factors which result in increase in gross profit.	8
	(b) Define depreciation and discuss various purposes of providing depreciation.	8
5.	Mention any **8** special points which you as an auditor would look into while auditing the books of accounts of :	8×2 = 16
	(a) Hospital	
	(b) Cinema	
6.	(a) Explain the concept of Joint Audit. Discuss its advantages and disadvantages.	8
	(b) Explain the powers of company to purchase its own securities.	8
7.	Write short notes on any **four** of the following :	4×4 = 16
	(a) Reissue of redeemed debentures.	
	(b) Internal control in Small Business	
	(c) Stratified Sampling	
	(d) Audit of expenditure in Government audit.	
	(e) Cut-off procedure.	

Roll No. ....

Total No. of Questions – **7**

Time Allowed – **3** Hours | Maximum Marks – **100**

Auditing and Assurance (May, 2012)

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi medium, his answers in Hindi will not be valued.

Question No. **1** is *compulsory*.

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

			Marks
1.		Discuss on the following :	
	(a)	Standards collectively known as the Engagements Standards issued by AASB under the authority of the council of ICAI.	5
	(b)	Payment of interest to the shareholders on capital raised by issue of shares to meet the cost of construction of building which cannot be made profitable for a long period.	5
	(c)	Distinguish between Reserves and Provisions.	5
	(d)	In Joint Audit, "each Joint Auditor is responsible only for the work allocated to him".	5
2.	(a)	What are the general considerations in framing a system of internal check ?	8
	(b)	Discuss the audit procedure for verification of payment of dividends.	8
3.	(a)	How will you verify/ vouch the retirement gratuity to employees ?	6
	(b)	Discuss appointment of Auditor by special resolution.	6
	(c)	State the matters which only the shareholders can sanction at a General Meeting.	4

Marks

4. (a) Explain "Going Concern" assumption with reference to SA. State some financial events or conditions that may cast doubt about going concern assumption. **8**

   (b) You are the auditor and examining the book debts of a company. Give some indications which leads to doubt about recovery as uncollectable debts from debtors and advances. **8**

5. (a) Mention the eight important points which an auditor will consider while conducting the audit of educational institutions. **8**

   (b) Explain the meaning of term " Subsequent Events" as used in the SA560. Should all types of subsequent events be considered by the auditor in his attest functions ? **8**

6. (a) Discuss CARO 2003 requirement with regard to internal audit system. What are the factors to be considered by the auditor to examine whether the internal audit system is commensurate with the size of the company and the nature of its business ? **8**

   (b) What are the advantages of an independent audit ? **8**

7. Write short notes on any **four** of the following : **4x4 =16**

   (a) Preliminary Expenses

   (b) Initial Engagements

   (c) Disadvantages of the use of an audit programme

   (d) Audit Techniques

   (e) Simple random sampling

Roll No. ……………………...

Total No. of Questions – **7**

Time Allowed – **3** Hours | Maximum Marks – **100**

Auditing and Assurance (November, 2012)

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi medium, his answers in Hindi will not be valued.

Question No. **1** is compulsory.

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

			Marks
1.		Discuss on the following :	
	(a)	Shares issued at a discount.	**5**
	(b)	Ceiling on number of audits in a company to be accepted by an auditor.	**5**
	(c)	Purposes of providing depreciation.	**5**
	(d)	Filling of a casual vacancy of auditor in respect of a company audit.	**5**
2.	(a)	Explain the concept of "True and Fair" view.	**6**
	(b)	Mention the areas in which differing accounting policies are encountered and how that would be disclosed ?	**10**
3.	(a)	What are the duties of Comptroller and Auditor General ?	**10**
	(b)	State any six basic elements of the Auditor's Report.	**6**
4.	(a)	What are the factors that are to be considered while designing a confirmation request ?	**8**
	(b)	Distinguish between Auditing and Investigation.	**8**

			Marks
5.	(a)	What are the eight audit points to be considered by the auditor during the audit of a Hospital ?	8
	(b)	As an auditor, how will you verify application and allotment money received on shares issued for cash ?	8
6.	(a)	What are the audit working papers ? Discuss various contents of current file.	8
	(b)	Explain, what are the factors to be considered while "Vouching of travelling expenses" ?	8
7.		Write short notes on any **four** of the following :	4×4 =16
	(a)	Audit of discounted bills receivable dishonoured.	
	(b)	Auditor's lien.	
	(c)	Inherent risk.	
	(d)	Cut-off arrangements.	
	(e)	Examination in depth.	

Roll No. ....

Total No. of Questions – 7

Time Allowed – **3** Hours | Maximum Marks – **100**

Auditing and Assurance (May, 2013)

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi medium, his/her answers in Hindi will not be valued.

Question No. **1** is compulsory .

Candidates are also required to answer any **five** questions from the remaining **six** questions.

Marks

1. (a) Discuss with reference to SAs :

(i) The auditor shall communicate all significant findings with those charged with Governance. **5**

(ii) Factors effecting form, contents and extent of audit. **5**

(b) Discuss the following :

(i) Is surprised checks desirable in audit, if so give important recommendations. **5**

(ii) Inquiry is one of the audit procedure to obtain audit evidence. **5**

2. Comment on any **eight** of the following : **8×2 = 16**

(i) PQR Ltd. include underwriting commission and stamp duty as preliminary expenses.

(ii) AGM is not held in time, auditor automatically vacates his office.

(iii) Selling and distribution cost included in the cost of inventories.

(iv) Internal check is part of internal control system.

Marks

(v) Company can provide lower rate of depreciation than prescribed by Schedule XIV of the Companies Act, 1956.

(vi) Compliance procedures are tests designed to obtain audit evidence as to completeness, accuracy and validity of data produced by accounting system.

(vii) ABC Ltd. having turnover of ₹ 100 crores during financial year 2011-12, need not get its branch audited whose turnover is ₹ 1.5 crores during the same year.

(viii) Computer software which is the integral part of the related hardware can be treated as intangible assets or fixed assets ?

(ix) CARO, 2004 does not apply to a foreign company .

(x) Define shortly arm's length transaction.

3. (a) What is continuous audit and what are the precautions which should be taken to avoid the disadvantages of continuous audit ? 8

(b) Explain the basic principles governing audit. 8

4. (a) To prepare an audit plan in CIS environment an auditor should gather information. Mention any four such important information which he has to collect. 4

(b) How will you vouch/verify the followings ? 3x4 =12

(i) Purchase with invoice

(ii) Patterns, dies, loose tools etc.

(iii) Work-in-Progress

5. (a) State the circumstances which could lead to any of the following in an Auditors Report : 4x2 =8

(i) A modification of opinion

(ii) Disclaimer of opinion

(iii) Adverse opinion

(iv) Qualified opinion

		Marks
	(b) What are the cases in which special audit may be called by Central Government ?	4
	(c) Anandbhai & Co. Ltd. issued shares to the equity shareholders in the proportion of one bonus share for every three existing shares. As an auditor of the Company how would you verify this issue ?	4
6.	(a) Mention important points which auditors will consider while conducting audit of accounts of a partnership firm.	8
	(b) What are the points on which an auditor should concentrate while planning audit of an N.G.O. ?	8
7.	Write short notes on any **four** of the followings :	4×4 =16
	(i) Audit Planning & Materiality	
	(ii) Impairment of Assets	
	(iii) Internal Control Questionnaire	
	(iv) Letter of Weakness	
	(v) Assertion about balance at the end of the reporting period.	

Roll No. ....

Total No. of Questions – **7**

Time Allowed – **3** Hours | Maximum Marks – **100**

Auditing and Assurance (November, 2013)

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi medium, his / her answers in Hindi will not be valued.

Question No. **1** is compulsory.

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

Marks

1. Discuss the following :

(a) Despite of several disadvantages, audit programme is required to start an audit. **5**

(b) The discipline of behavioural science is closely linked with the subject of auditing. **5**

(c) The reliability of audit evidence is influenced by its source, nature and circumstances under which it is obtained. **5**

(d) As per SA 530, meaning of audit sampling, sample design, sample size and selection of items for testing. **5**

Marks

2. State with reason (in short) whether the following statements are correct or incorrect. (Any **Eight**) 8×2 =16

(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.

Marks

3. (a) Explain inherent limitations of internal control system. 8

(b) With reference of SA 250 give some examples or matters indicating to the auditor about non compliance of laws & regulations by management. 8

4. How will you vouch and verify the following ? 4×4 =16

(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.

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

(b) Under what circumstances the retiring auditor can not be reappointed ? 6

(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

6. (a) What procedure may be adopted by an auditor, while auditing leasing transactions entered into by the leasing company ? 8

(b) Mention any eight important points which an auditor will consider while conducting audit of club ? 8

Marks

7. Write short notes on any **four** of the following : **4×4 =16**

(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.

COMPILATION
OF
SUGGESTED ANSWERS
TO
QUESTIONS

SET AT THE

INSTITUTE'S EXAMINATIONS
(MAY, 2004 – NOVEMBER, 2013)

INTERMEDIATE (IPC) COURSE

PAPER – 6

AUDITING AND ASSURANCE

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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Paper -6: Auditing and Assurance

Statement indicating chapter-wise distribution of past twenty examination questions

Term of Examination	Chapter - 1: Nature of Auditing	Chapter - 2: Basic Concepts in Auditing	Chapter - 3: Preparation for an Audit	Chapter - 4: Internal Control	Chapter - 5: Vouching	Chapter - 6: Verification of Assets and Liabilities	Chapter – 7: The Company Audit - I	Chapter – 8: The Company Audit - II	Chapter – 9: Special Audits
May 2004	4(b)	8(c)	3(a), 8(b)	3(b), 4(a), 7(b)	2(b), 6(b), 6(c)	1(a), 1(b), 6(a), 6(d), 8(a), 8(d)	2(a), 2(c), 2(d), 5	1(c)	7(a)
Nov 2004	1(a), 1(b), 1(d), 3(a), 4(b), 7(b), 8(a)	2(a)		8(d)	5(a), 5(b), 7(a)	5(c), 5(d), 8(c)	2(b), 2(c), 2(d), 2(e), 3(b), 8(b)	1(c)	4(a), 6
May 2005		4(b), 7(a)(ii)	6(b), 7(a)(i), 7(b), 8(a)	3(b), 8(b)	5(a), 5(d)	2(a)(ii), 5(b), 5(c)	1(b), 1(c), 1(d), 2(a)(i), 2(b), 4(a), 8(c)	1(a), 8(d)	3(a), 6(a)
Nov 2005	1(a), 1(b), 2(a)(ii), 3(a), 3(b), 8(a), 8(c)	2(b)	2(c), 6(a), 8(b)	5(b)	4(a), 4(d), 8(d)	1(d), 4(b), 4(c)	1(c), 2(a)(i), 7(a)	7(b)	5(a), 6(b)
May 2006	1(c), 7(a), 8(c)		7(b)	3(a), 6(a)	1(a), 4(d), 8(b)	3(b), 4(a), 4(b), 4(c), 8(d)	1(b), 2(a), 2(b), 2(c), 2(d), 8(a)	1(d)	5(a), 5(b), 6(b)
Nov 2006	1(a), 1(b), 1(c), 2(c), 3(a), 6(b), 8(b), 8(c), 8(d)		8(a)	1(d), 5(b)	3(b), 4(a), 4(b), 4(d), 7(a)		2(a), 2(b), 6(a), 7(b)	4(c)	2(d), 5(a)

May 2007	1(v), 1(viii), 1(xii), 2(a), 2(b), 2(c)	1(xi)	1(iv), 1(vii), 3(a), 5(b), 8(b), 8(c)	3(b), 4(b), 6(a)	1(iii), 1(ix), 7(a), 7(b)(ii)	4(a), 7(b)(i), 7(c)	1(i), 1(ii), 1(vi), 1(x), 5(a)		6(b), 8(a)
Nov 2007	1(iii), 1(iv), 1(v), 2(b)	1(vii), 6(b)	1(i), 2(a), 2(c), 3(a), 8(b)(i)	4(a), 5(a), 8(c)	7(a), 7(b)(ii), 8(b)(ii)	4(b), 7(b)(i), 7(c)	1(ii), 1(vi), 1(vii), 1(x), 1(xi), 1(xii), 5(b)	1(ix), 3(b)	6(a), 8(a)
May 2008	1(i), 1(v), 1(vii), 1(ix), 2(a), 2(b), 2(c), 3(b), 5(b)	1(xii), 3(a), 8(a)	1(ii), 1(iii), 6(b), 8(b)(ii), 8(c)	4(a)	7(a), 7(b)(i)	1(vi), 1(viii), 7(b)(ii), 7(c)	1(iv), 1(x), 1(xi), 4(b)	5(a)	6(a), 8(b)(i)
Nov 2008	1(iii), 1(vi), 1(vii), 2(c), 3(a), 3(b)	6(b)	1(viii), 1(x), 4(a)	1(ix), 2(b), 4(b)	7(a), 7(b)(ii), 7(c)	1(i), 2(a), 7(b)(i), 8(c)(i)	1(iv), 1(v), 1(xii), 5(b), 8(a), 8(c)(ii)	1(ii), 1(xi), 5(a), 8(b)	6(a)
Jun 2009	1(i), 1(v), 1(vi), 1(vii), 1(viii), 1(ix), 1(xi), 4(a), 4(b), 6(a), 6(b)	3	1(iii), 8(c)(i)	1(ii), 5(a), 8(b)	2(b), 7(a), 7(c)	1(x), 2(a), 5(b), 7(b), 8(a)	1(iv), 1(xii), 2(c), 8(c)(ii)		
Nov 2009	1(iv), 1(x), 1(xi), 3	4(a)	1(i), 1(v), 4(b), 8(a), 8(b)(ii)	1(xii)	7(b)(ii), 8(b)(i)	5(b), 7(b)(i), 7(c)	1(iii), 1(vi), 1(vii), 1(viii), 1(ix), 2(a), 2(b), 2(c), 7(a)	1(ii), 6(a), 6(b)	5(a), 8(c)
May 2010	1(vi), 5(b), 6(b)	8(a)	8(b)	4(a), 6(a)	1(ii), 1(iii), 3	1(v), 1(ix)	1(i), 1(iv), 1(vii), 1(x), 2(a), 2(b), 2(c), 4(b)	1(viii), 7(a), 7(b)	5(a)

Nov 2010	1(a), 1(c), 3(a), 3(b), 4(a), 4(d), 4(e), 6(b), 6(c), 6(d)	2(c)	7(c)	2(a), 2(b)	4(c), 7(a)		1(b), 1(d), 4(b), 5(c), 6(a), 7(b)		5(a), 5(b)
May 2011	1(a), 1(b), 1(c), 1(d), 3(a), 3(b)	2(a)	7(c)	7(b)	2(b), 4(a), 7(e)	4(b)	6(a)	6(b), 7(a)	7(d), 8(a), 8(b)
Nov 2011	3(a), 6(a), 6(b)		1(a), 7(a), 7(e)	2(a), 4(a)	1(b)	1(d), 6(c), 7(c), 7(d)	1(c), 4(b)	2(b), 3(b)	5(a), 5(b)
May 2012	1(a), 5(b), 6(b)	4(a)	7(b) 7(c), 7(d), 7(e)	2(a)	3(a)	1(c), 4(b), 7(a)	1(d), 3(b), 3(c), 6(a)	1(b), 2(b)	5(a)
Nov 2012	4(a), 4(b)	2(a), 2(b)	6(a)	7(c), 7(d)	6(b), 7(a), 7(e)	1(c)	1(b), 1(d), 3(b), 7(b)	1(a), 5(b)	3(a), 5(a)
May 2013	1(a), 2(iii), 2(viii), 2(x), 3(b)	1(b)(ii), 2(vi), 7(v)	1(b)(i), 3(a), 7(i)	2(iv), 4(a), 7(iii), 7(iv)	2(i), 4(b)(i)	2(v), 4(b)(ii), 4(b)(iii), 7(ii)	2(ii), 2(vii), 2(ix), 5(a), 5(b)	5(c)	6(a), 6(b)
Nov 2013	1(b), 1(d), 2(c), 2(i), 3(b), 7(d)	1(c), 2(h)	1(a), 2(f), 7(c)	2(b), 3(a), 7(b)	4(a), 4(c), 4(d)	4(b), 7(e)	2(a), 2(d), 2(e), 2(g), 2(j), 5(a), 5(b)	5(c)	6(a), 6(b), 7(a)

CONTENTS

1

Nature of Auditing

Question 1

Discuss the following:

(a) The discipline of behavioural science is closely linked with the subject of auditing.

(b) Discuss "As per SA 530, meaning of audit sampling, sample design, sample size and selection of items for testing". (5 Marks each, November, 2013)

Answer

(a) 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. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

(b) 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.

(a) *Branch auditor of a company should give photocopies of his working papers on demand by Company Auditor.*

(b) *Events occurring after the balance sheet date must be disclosed in the financial statements.* *(2 Marks each, November, 2013)*

Answer

(a) **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.

(b) **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.

Question 3

With reference of SA 250 give some examples or matters indicating to the auditor about non compliance of laws & regulations by management. *(8 Marks, November, 2013)*

Answer

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:

(i) Investigations by regulatory organisations and government departments or payment of fines or penalties.

(ii) Payments for unspecified services or loans to consultants, related parties, employees or government employees.

(iii) 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.

(iv) Purchasing at prices significantly above or below market price.

(v) Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.

(vi) Unusual payments towards legal and retainership fees.

(vii) Unusual transactions with companies registered in tax havens.

(viii) Payments for goods or services made other than to the country from which the goods or services originated.

(ix) Payments without proper exchange control documentation.

(x) Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.

(xi) Unauthorised transactions or improperly recorded transactions.

(xii) Adverse media comment.

Question 4

Write short notes on "Identification of significant related party transaction outside business".

(4 Marks, November, 2013)

Answer

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:

   (a) 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;

   (b) The terms of the transactions are consistent with management's explanations; and

   (c) 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 authorized and approved.

Question 5

Discuss with reference to SAs:

(i) The auditor shall communicate all significant findings with those charged with Governance.

(ii) Factors effecting form, contents and extent of audit. *(5 Marks each, May, 2013)*

Answer

(i) **As per SA-260 "Communication with Those Charged with Governance"**, the auditor shall communicate the following significant findings from the audit, with those charged with governance:

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

(ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

(ii) **As per SA-230 on "Audit Documentation"**, the form, content and extent of audit documentation depend on the following factors:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

Question 6

Comment on the following:

(a) Selling and distribution cost included in the cost of inventories.

(b) Computer software which is the integral part of the related hardware can be treated as intangible assets or fixed assets?

(c) Define shortly arm's length transaction. *(2 Marks each, May, 2013)*

Answer

(a) **As per AS-2 on Valuation of Inventories**, in determining the cost of inventories, it is appropriate to exclude selling and distribution costs and recognise them as expenses in the period in which they are incurred. Therefore, it is not appropriate to include selling and distribution cost in the cost of inventories.

(b) **As per AS-26 on Intangible Assets**, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. Therefore, computer software which is the integral part of the related hardware should be treated as fixed asset.

(c) **Arm's length transaction** - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Question 7

Explain the basic principles governing audit. *(8 Marks, May, 2013)*

Or

Discuss the basic principles governing an audit. *(10 Marks, November, 2009)*

Or

What are the basic principles which govern the Auditor's professional responsibilities while doing Audit? *(5 Marks, November, 2008)*

Answer

Basic Principles Governing an Audit: The basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried are described below:

(i) **Integrity, objectivity and independence:** The auditor should be straight forward, honest and sincere in his approach to his professional work. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever is actual effect, as being incompatible with integrity and objectivity.

(ii) **Confidentiality:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) **Skills and Competence:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence along with a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

(iv) **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditors and experts, he continues to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

(v) Documentation: The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) Planning: *The* auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

(vii) Audit evidence: The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) Accounting system and Internal Control: The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

(ix) Audit Conclusions and Reporting: The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a clear written opinion on the financial information and should comply the legal requirements. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

(**Note**: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics read with SA 200(Revised) and SA 220. But in general abovementioned principles are basic principles only)

Question 8

(a) What are the factors that are to be considered while designing a confirmation request?

(b) Distinguish between Auditing and Investigation. (8 Marks each, November, 2012)

Answer

(a) As per SA -505 "External Confirmations", the design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses. **The following factors should be considered while designing a confirmation request:-**

(i) The assertions being addressed.

(ii) Specific identified risks of material misstatement, including fraud risks.

(iii) The layout and presentation of the confirmation request.

(iv) Prior experience on the audit or similar engagements.

(v) The method of communication

(vi) Management's authorisation to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.

(vii) The ability of the confirming party to provide the requested information.

(b) Distinction between Auditing and Investigation: Auditing is different from investigation which is another significant service, a professional accountant renders. Investigation is a critical examination of the accounts with a special purpose. For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, *e.g.*, the extent of waste and loss, profitability, cost of production, etc. It normally concerns only specified areas, but at times, it may involve the whole field of accounting. Its essence lies in going into the matter with some pre-conceived notion suited to the objective. The techniques fit the circumstances of the case. For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view.

Audit never undertakes discovery of specific happenings and is never started with a pre-conceived notion about the state of affairs. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the *prima facie* findings of the auditor.

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Whereas investigation aims at establishing a fact or a happening or at assessing a particular situation.

However, as per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 9

Discuss "Standards collectively known as the Engagements Standards issued by AASB under the authority of the council of ICAI". (5 Marks, May, 2012)

Answer

Engagement Standards: The following standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards.

(i) Standards on Auditing (SAs), to be applied in the audit of historical financial information.

(ii) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.

(iii) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.

(iv) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

Question 10

Explain the meaning of term "Subsequent Events" as used in the SA 560. Should all types of subsequent events be considered by the auditor in his attest functions? (8 Marks, May, 2012)

Answer

Meaning of Subsequent Events: SA 560 on "Subsequent Events", defines the term 'subsequent events" as events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

"Subsequent events" also refer to significant events which occurred up to the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor.

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

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

Question 11

What are the advantages of an independent audit? (8 Marks, May, 2012)

Answer

Advantages of an Independent Audit: The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

(i) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.

(ii) It acts as a moral check on the employees from committing defalcations or embezzlement.

(iii) Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(iv) These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(v) An audit can also help in the detection of wastages and losses to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

(vi) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.

(vii) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

(viii) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(ix) Government may require audited and certified statements before it gives assistance or issues a license for a particular trade.

Question 12

Explain the process of external confirmation. Give some examples where external confirmation can be used as audit evidence. *(8 Marks, November, 2011)*

Answer

External Confirmation: According to SA 505 on " External Confirmation, it is the process of obtaining and evaluating through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by the management in the financial statements. When using external confirmation procedures, the auditor shall maintain control over external control requests, including:

(i) Determining the information to be confirmed or requested;

(ii) Selecting the appropriate confirming party;

(iii) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(iv) Sending the requests, including follow-up requests when applicable, to the confirming party.

(v) Selecting the items for which confirmations are needed.

Examples of situations where external confirmations may be used include the following:

(i) Bank balances and other information from bankers.

(ii) Accounts receivable balances.

(iii) Inventories held by third parties.

(iv) Property title deeds held by third parties.

(v) Investments purchased but delivery not taken.

(vi) Loans from lenders.

(vii) Accounts payable balances.

(viii) Long outstanding share application money.

(ix) Terms of Agreement or transaction with the third parties.

Question 13

(a) Discuss the areas in which different accounting policies may be adopted.

(6 Marks, November, 2011)

(b) Discuss the types of audits required under law. *(5 Marks, November, 2011)*

Answer

(a) Areas in which Different Accounting Policies are adopted: Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

There is no single list of accounting policies which are applicable to all circumstances. The different circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise require for considerable judgment by the management of the enterprise.

The following are examples of the areas as given in AS- 1, Disclosure of Accounting Policies in which different accounting policies may be adopted by different enterprises.

(i) Method of depreciation, depletion and amortization.

(ii) Valuation of fixed assets.

(iii) Valuation of inventories.

(iv) Valuation of goodwill.

(v) Valuation of investment.

(vi) Treatment of retirement benefits.

(The above list is not exhaustive. There may be other examples as well.)

(b) Audit required under Law: Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

The organisations which require audit under law are the following:

(i) Companies governed by the Companies Act, 2013;

(ii) Banking companies governed by the Banking Regulation Act, 1949;

(iii) Electricity supply companies governed by the Electricity Supply Act, 1948;

(iv) Co-operative societies registered under the Co-operative Societies Act, 1912;

(v) Public and charitable trusts registered under various Religious and Endowment Acts;

(vi) Corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India.

(vii) Specified entities under various sections of the Income-tax Act, 1961.

(viii) Audit required under Sales-tax and VAT by various State Government.

Question 14

Comment on the following in relation to SAs:

(a) "The work performed by each assistant needs to be reviewed by personnel of at least equal competence."

(b) "Audit documentation serves a number of additional purposes."

(c) "Management is responsible for compliance with laws and regulations."

(d) "Auditor shall establish an overall strategy that sets the scope, timing and directions of the audit, and that guides the development of the audit plan." (5 Marks each, May, 2011)

Answer

(a) Reviewing the work performed by Assistant : As per SA 220 "Quality Control for an Audit of Financial Statements" the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members. However, it has placed the final responsibility of review of audit engagement on engagement partner.

Engagement partner is the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Reviews at appropriate stages, during the audit engagement allow significant matters to be resolved on a timely basis, to the engagement partner's satisfaction on or before the date of the auditor's report.

The engagement partner shall ensure that reviews being performed are in accordance with the firm's review policies and procedures. A review consists of consideration whether, for example:

(i) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(ii) Significant matters have been raised for further consideration;

(iii) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(iv) There is a need to revise the nature, timing and extent of work performed;

(v) The work performed supports the conclusions reached and is appropriately documented;

(vi) The evidence obtained is sufficient and appropriate to support the auditor's report; and

(vii) The objectives of the engagement procedures have been achieved.

(b) Audit Documentation: According to SA 230 on "Audit Documentation", audit documents once collected serves a number of additional purposes. These purposes are as follows:-

(i) Assisting the engagement team to plan and perform the audit.

(ii) 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 "Quality Control for an Audit of Financial Statements".

(iii) Enabling the engagement team to be accountable for its work.

(iv) Retaining a record of matters of continuing significance to future audits.

(v) Enabling the conduct of quality control reviews and inspections.

(vi) Enabling the conduct of external inspections in accordance with applicable legal regulatory or other requirements.

(c) Management's responsibility for compliance with laws and regulations: According to SA 250 on "Consideration of Laws and Regulations in an Audit of Financial Statements", it is management's responsibility, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations. Laws and regulations may affect an entity's financial statements in different ways for example, most directly; they may affect specific disclosures required of the entity in the financial statements. The following are the procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:-

(i) Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.

(ii) Instituting and operating appropriate systems of internal control.

(iii) Developing, publicising and following a code of conduct.

(iv) Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.

(v) Engaging legal advisors to assist in monitoring legal requirements.

(vi) Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

(vii) Ensuring employees are properly trained and understand the code of conduct.

(d) Establishment of overall strategy for development of audit plan: According to SA 300, "Planning an Audit of Financial Statements" the auditor shall establish an overall audit strategy that sets the scope, timing and directions of the audit, and that guides the development of the audit plan.

In establishing the overall audit strategy, the auditor shall:

(i) Identify the characteristics of the engagement that define its scope;

(ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(iii) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

(iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(v) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Question 15

(a) Discuss Limitation of audit.

(b) Discuss pre-requisites and fundamental principles to be possessed by an auditor.

(8 Marks each, May, 2011)

Answer

(a) Limitations of Audit: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from:

(i) **The Nature of Financial Reporting**: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.

(ii) **The Nature of Audit Procedures**: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(iii) **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** The relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

(iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.

- Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

(b) Prerequisites or fundamental principles to be possessed by an Auditor: It is in the best interest of the accountancy profession to make known to users, of the services provided by an auditor that they are executed at the highest level of performance and are in accordance with ethical requirements that strive to ensure such performance. In order to achieve the objectives of accountancy profession, the auditor have to observe a number of prerequisites' or fundamental principles as under:

(i) **Integrity:** An auditor should be straight forward and honest.

(ii) **Objectivity:** An auditor should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override professional judgments.

(iii) **Professional competence and due care:** An auditor should perform his duty with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

(iv) **Confidentiality:** An auditor should respect the confidentiality of information acquired during the course of an audit and should not use or disclose any such information to third parties without proper and specific authority or unless there is a legal or professional right or duty to disclose.

(v) **Professional behaviour:** An auditor should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession.

(vi) **Technical Standard:** An auditor should carry out professional services in accordance with the relevant technical and professional standards.

Question 16

Comment as an auditor on the following situations:

(a) Mr. X, a partner in X & Co., a firm of a Chartered Accountants, died on 31-3-2010 after completing routine audit work of XYZ Company Ltd. Mr. Y another partner of the firm of Chartered Accountants signed the financial statements of XYZ Company Ltd., without reviewing the finalization work done by the assistants.

(b) M.N.P. Company Ltd. purchased a machinery for ₹ 1.00 crore. The State Government granted the company a subsidy of ₹ 40 lakhs to meet partial cost of machinery. The company credited the subsidy received from the State Government to its Profit and Loss Account for the year ended March 31, 2010. *(5 Marks each, November, 2010)*

Answer

(a) Relying on work performed by others : SA 220, Quality Control for an Audit of Financial Statements, an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; Significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, when the auditor delegates work to assistants or uses work performed by other auditors/experts he will continue to be responsible for forming and expressing his opinion on the financial statements. However, he will be entitled to rely on the work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. The auditor should carefully direct supervise and review work delegated to assistants. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

Conclusion: In the instant case, Mr. X, a partner of the firm had completed routine audit work and died on 31 March, 2010. Mr. Y another partner of the firm has signed the financial statement of XYZ Company Ltd, without reviewing the finalization work done by the assistants. Mr. Y will be fully responsible for negligence, he cannot take the shelter that Mr. X had done the work.

Hence, Mr. Y has negligently performed his duties.

(b) Accounting treatment for Government Grants: As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets.

Following are two methods of presentation of grants related to specific fixed assets in financial statements as acceptable alternatives.

(i) Under the first alternative the grant is shown in the balance sheet as a deduction from the gross value of the assets concerned. The grant is recognized in profit and loss accounts over the useful life of the depreciable life of asset by way of a reduced depreciation charge.

(ii) Under second alternative, it is treated as a deferred income which should be recognized in profit and loss account over useful life of asset in proportion in which depreciation will be charged on the assets concerned. Deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description i.e. Deferred Government Grant.

Conclusion: In the instant case, M.N.P. Company Ltd. received a subsidy from government worth ₹ 40 lakhs towards meeting partial cost of machinery. The company credited the same to its Statement of Profit and Loss.

Accounting treatment of grant received towards partial cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report bringing out the quantification impact clearly.

Question 17

(a) "The auditor is faced with sampling risk in both tests of control and substantive procedures."

Comment on this statement with reference to SA 530 on "Audit Sampling".

(b) What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures". *(8 Marks each, November, 2010)*

Answer

(a) Sampling Risk: (SA 530): Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(b) Extent of reliance on analytical procedures (SA-520): The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(i) Materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material.

(ii) Other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts.

(iii) Accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(iv) Assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

(v) The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Question 18

Write short notes on the following:

(a) Reliability of external confirmations.

(b) Factors governing modes of communication of auditor with those charged with governance.

(c) *Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption.* *(4 Marks each, November, 2010)*

Answer

(a) Reliability of external confirmations: As per SA 505 "External Confirmation", the reliability of external confirmations depends among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures.

The factors that affect the reliability of confirmations include:

(i) The control which the auditor exercises over confirmation request and responses;

(ii) The character of respondents and

(iii) Any restrictions included in the response or imposed by the management.

(b) Factors governing modes of communication of auditor with those charges with governance: As per SA 260, "Communication with Those Charge with Governance" the auditor may decide whether to communicate orally or in writing. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The form of communication may be affected by such factors as:

(i) Whether the matter has been satisfactorily resolved.

(ii) Whether management has previously communicated the matter.

(iii) The size, operating structure, control environment, and legal structure of the entity.

(iv) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

(v) Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.

(vi) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(vii) The amount of ongoing contact and dialogue the auditor has with those charged with governance.

(viii) Whether there have been significant changes in the membership of a governing body.

(c) Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption: As per SA 570, "Going Concern"**,** the following are the relevant procedures that are relevant in this connection:

(i) Analyse and discuss cash flow, profit and other relevant forecasts with management.

(ii) Analyse and discuss the entity's latest available interim financial statements.

(iii) Review the terms of debentures and loan agreements and determine whether any of the terms have been breached.

(iv) Read minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.

(v) Inquire of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.

(vi) Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.

(vii) Evaluate the entity's plans to deal with unfilled customer orders.

(viii) Perform audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

(ix) Confirm the existence, terms and adequacy of borrowing facilities.

(x) Obtain and review reports of regulatory actions.

(xi) Determine the adequacy of support for any planned disposals of assets.

Question 19

Comment on the following:

(a) A partnership firm revalued its fixed assets like land and building. The firm adequately disclosed the revalued amounts in the Balance Sheet.

Do you, as an auditor, approve the disclosure given by the partnership firm?

(b) R.K. & Company are the auditors of PQR Company Ltd. The Managing Director of the Company demands copies of the working papers from the auditors. Are the auditors bound to oblige the Managing Director?

(c) "Responsibility for properly determining the quantity and value of inventory rests with the management." Comment on this statement. *(4 Marks each, November, 2010)*

Answer

(a) Disclosure of revalued fixed assets of a partnership form: As per AS 10 "Accounting for fixed assets", revalued amounts substituted for historical costs of fixed assets, method adopted to compute the revalued amounts, nature of indices used, year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts should be disclosed in the financial statements.

In the instant case, the partnership firm revalued its fixed assets like building and land and adequately disclosed the revalued amounts in the Balance sheet. The firm did not disclose the method adopted by it for arriving at the revalued figures.

Conclusion: The firm had disclosed the revalued amounts in the balance sheet but the method and nature of indices used etc. are not disclosed. Thus, this act of the firm is in contravention with the AS 10 for "Accounting for Fixed Assets'.

Hence, the auditor cannot approve the disclosure given by the partnership firm and shall have to qualify the report.

(b) Ownership and custody of working papers: As per SA-230 "Audit Documentation", the working papers are the property of the auditor, the auditor may, at his discretion make portion of or extracts from his working papers available to the client.

In the instant case the managing director of the company has demanded copies of the working papers from the auditor. He has no right to obtain copies of the working papers from the auditor because they are the property of the auditor. However the auditor may at his discretion make portions of or extracts from the working paper to the managing director of PQR & Company Ltd.

Conclusion: The auditor is not bound to oblige the managing director by supplying copies of the audit working papers.

(c) Management's responsibility for determining quantity and value of Inventory: "Guidance note on Audit of Inventories" specifies that the responsibility for properly determining the quantity and volume of inventories rests with the management of the entity. Therefore it is the responsibility of the management of the entity to ensure that inventories included in financial statements are physically in existence and represent all owned by the entity.

The management can satisfy this responsibility by carrying out appropriate procedures such as verification of all items of inventory at least once in every financial year. The auditor is expected to examine the compliance of "Accounting Standard 2: Valuation of Inventory" and adequacy of the method and procedures of physical verification followed by the entity .He is also required to determine whether the procedure for identifying defective, damaged, obsolete and slow moving items are well designed and operate properly that proper books of accounts should be made following the accounting standards

The responsibility of management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents depends on the facts and circumstances of each case.

Question 20

State with reasons (in short) whether the following statement is True or False:

When an auditor identifies a Misstatement resulting from fraud, it is his responsibility to communicate it to the regulatory and enforcement authorities apart, from those charged with governance. *(2 Marks, May, 2010)*

Answer

True: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", if an auditor identifies a fraud or has obtained information that indicates that a fraud may exist, it is his responsibility to communicate the matter with those charged with the governance on a timely basis and, in some circumstances, when so required by laws or regulations, to regulatory and enforcement authorities also.

However, as per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 21

'The extent of audit procedure performed on corresponding figure is less compared to audit of current period figures', reporting. Justify the statement with regard to auditor's duties for reporting of comparatives under SA 710. *(5 Marks, May, 2010)*

Answer

Comparatives: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements" the following are the broad principles"

(i) The auditor should obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework.

(ii) When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.

(iii) When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification in the audit report is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

   (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

   (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

(iv) If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

(v) If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Question 22

'A Joint Auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report.'

Justify this statement in the light of responsibilities of Joint Auditors under SA 299.

(5 Marks, May, 2010)

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" prescribes the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act. Main features of the said SA are discussed below:

- **Division of Work:** Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- **Coordination:** Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

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

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

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

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

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

(vi) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

(vii) the responsibility of obtaining and evaluating information and explanation from the management is generally a responsibility of all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility.

(viii) each joint auditor is entitled to assume that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 23

State with reasons (in short) whether the following statements are True or False:

(i) The auditor, in the interest of the users, while explaining the nature of his reservation, can describe the work of the expert with his name, in the audit report without obtaining prior consent of the expert.

(ii) Analytical procedures are unable to help the Auditor in determining the nature, timing and extent of other audit procedures at the planning stage.

(iii) A Company which has been unable to negotiate borrowings from its bankers claims that it will be able to continue as a 'going concern'. (2 Marks each, November, 2009)

Answer

(i) False: As per SA 620, "Using the Work of an Auditor's Expert", if the auditor, in the interest of the users includes the name of the expert in his audit report, he can do so only after obtaining the prior permission of the auditor's expert.

(ii) True: As per SA 520 "Analytical Procedures" states that the auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

(iii) **False:** In the case of the company which has not been able to negotiate its borrowings with its bankers, there will be a substantial doubt in its ability to continue as a going concern without such financial support.

Alternative Answer – True: If the company is not able to negotiate borrowings from its bankers for reasons like delay/failure in the submission of adequate documents/information or for other reasons other than the company's financial status then the statement is true.

Question 24

State with reasons (in short) whether the following statements are True or False:

(i) *The principle of confidentiality precludes auditor to disclose the information about the client to a third party at all circumstances without any exception.*

(ii) *It is no part of subsequent auditor's duty to verify opening balances of Ledger accounts of current years, on the basis of Balance Sheet audited by Previous Auditor.*

(iii) *AAS 25 (SA 710) on 'comparatives' is applicable to corresponding previous years figures and not to comparative Financial statement.*

(iv) *AS 10 "Accounting for fixed assets" is also applicable to wasting assets like quarries, minerals and oil and natural gas.*

(v) *When Government grants are received in the form of assets such as land, plant and equipments etc., free of cost, then, such assets should be entered in the books of accounts at nominal value.*

(vi) *Contingent liabilities are provided for in the accounts if they crystallize between the end of the accounting year and the date of signing the audit report.*

(vii) *A branch auditor is a joint auditor according to AAS 12 (SA 299) and his relationship with the company auditor is governed by the said Standard.* *(2 Marks each, June 2009)*

Answer

(i) **False:** The principle of confidentiality is one of the basic principles of auditing. Auditor is generally not expected to divulge the information of his client to others. But it is not the case always. He can disclose the information to others if (a) permitted by his client and (b) if he has to disclose it as per any statutory obligation dictated by any law.

(ii) **False:** According to SA 510 "Initial Audit Engagements—Opening Balances", it is the duty of the auditor to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements.

(iii) **False:** As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", there are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information**:**

corresponding figures and comparative financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510 "Initial Audit Engagements—Opening Balances" regarding opening balances also apply.

(iv) False: AS 10 "Accounting for Fixed Assets" clearly states that this Accounting Standard is not applicable to wasting assets like quarries, minerals oil and natural gas.

(v) True: According to AS 12 "Accounting for Government Grants " when Government grants in the form of non-monetary assets such as land, plant and equipments etc. are received free of costs then such assets should be entered in the books of account at nominal value.

(vi) True: AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a provision should be recognised when, an enterprise has a present obligation as a result of a past event; it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation.

Furthermore, as per AS 4 "Contingencies and Events Occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events, occurring between the balance sheet date and the date on which the financial statements are approved, that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

(vii) False: Branch auditor is not a joint auditor within the meaning of SA 299 "Responsibility of Joint Auditors". He is an another auditor within the meaning of SA 600 "Using the Work of Another Auditor".

Question 25

(a) M, Statutory Auditor of ABC Ltd wants to verify cash on hand as on 31st March, 2009. The Management informs Mr. M. that it is not possible to cooperate, as cashier has been hospitalised. Advise Mr. M. on how to deal with the situation. (4 Marks, June 2009)

(b) As an auditor of a Limited Company, you observe that during the month of March, 2009, sales invoices were not recorded in books of accounts. You also observe that payment of wages was much higher compared to last year. Keeping in mind the above, analyse possible ways of manipulation of accounts. (6 Marks, June 2009)

Answer

(a) Limitation on the scope of Audit: The scope of audit may be limited for varied reasons, (i) the entity may impose restriction on scope of audit, (ii) the limitation may be imposed by circumstances.

When the audit is carried out under and as per statute, the auditor should not accept the assignment when his duties are curtailed by agreement, unless required by any Law.

When audit is carried out in accordance with the entity's terms voluntarily, the auditor may indicate his scope in his audit report.

Sometimes, the circumstances may impose restrictions on audit scope. For example, if the auditor is appointed after the year end, he may not be able to participate in inventory checking. Or sometimes, the records required may not be available so that the auditor may not be able to check details in the manner he liked. Such limitations in scope may warrant an auditor to express disclaimer of opinion or qualified opinion in his audit report depending upon the circumstances.

The non co-operation of ABC Limited will amount to limitation on scope of auditors.

(b) Manipulation of Accounts: Accounts are falsified in order to conceal the true position of the business for some purpose. They are always intentional, for a predetermined purpose and are generally committed either by the owners or top management personnel or senior officers of the business. This type of fraud is generally committed:

(i) to avoid incidence of income-tax or other taxes by showing profits at a lower figure.

(ii) for delaying a dividend when there are insufficient profits by showing profits at inflated figures.

(iii) to withhold declaration of dividend even there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost).

(iv) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Such frauds are difficult to be detected as they are committed by persons holding position of trust and use carefully guarded by them. Such frauds are generally of the following nature:

(i) Recording fictitious sales or omission of sales

(ii) Recording fictitious purchases or suppression of purchases

(iii) Over valuation or under valuation of stock.

(iv) Recording fictitious expenses or omission of expenses

(v) Taking credit for accrued income not likely to be received or omission of income.

(vi) Revenue expenses changed to capital and vice-versa.

SA 240 "The Auditor's Responsibilities relating to fraud in an Audit of Financial Statements" states that the Auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. If an auditor identifies a fraud or has obtained information that indicates that a fraud may exist, it is his responsibility to communicate the matter with those charged with the governance on a timely basis and, in some circumstances, when so required by laws or regulations, to regulatory and enforcement authorities also. In addition, as per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

An auditor who uses adequate skill and reasonable care, is legally exempt from liability if he fails to discover a well concealed detection. But an auditor by a skilled auditor should rarely permit such a failure.

All possible opportunities for dishonesty and manipulation of the accounts must be considered and guarded against and the degree of checking and investigation should be determined by the circumstances surrounding the transactions and the effectiveness of the system of intended check in operation.

Question 26

(a) A Limited Company has filed a suit against debtor from whom ₹25 lakhs are receivable. A judgement is received from court in favour of the company after the date of Balance Sheet. Discuss auditors' duty in this regard. (6 Marks, June, 2009)

(b) While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer. (4 Marks, June, 2009)

Answer

(a) Subsequent events: Subsequent events are events occurred after balance sheet date but before the date of audit report. In case of audit of components, such as branch or division the subsequent events are events after the balance sheet date and before the date of audit report of that component.

The subsequent events, according to AS 4 “Contingencies and Events Occurring after the Balance Sheet Date” and as reproduced in SA 560 “Subsequent Events” are of two types – (a) those which provide further evidence of conditions that existed at the balance sheet date and (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Depending upon the type of subsequent events, the auditor should decide on adjustment of accounts based on evidential value gathered for conditions that existed as on the date of balance sheet date or disclosure of the conditions that arose subsequent to the date of balance sheet.

The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements have been identified. These procedures would include inquiring of management as to whether any subsequent events have occurred which might affect the financial statements, reading minutes of Board subsequent to accounting period, contacting lawyers for knowing progress of pending Cases, inquiry with the company management, scrutinizing subsequent interim accounts etc. The auditor should perform these procedures as near as practicable to the date of his audit report. If the management does not account for the subsequent events in the financial statements where they are to be accounted, the auditor should appropriately comment his report by a qualification or disclaimer.

(b) **Using the Work of an Auditor's Expert:** The Auditor while considering advances granted by bank for purchase of machinery has to consider valuation report given by civil engineer to the bank.

As per SA 620 "Using the Work of an Auditor's Expert", the auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. Competence relates to the nature and level of expertise of the auditor's expert, capability relates to the ability of the auditor's expert to exercise that competence in the circumstances of the engagement and objectivity relates to the possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the auditor's expert. Information regarding these factors can be obtained from various sources such as personal experience with previous work of that expert, knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition etc.

If auditor finds that civil engineer can not be considered expert for valuation of machinery, he should insert on other analytical procedures to confirm the value of machinery. Even after this, if he is not satisfied, he should give qualified opinion.

Question 27

State with reasons (in short) whether the following statements are True or False:

(i) *AAS-11 is related to Audit Materiality.*

(ii) *Audit Working Papers to be kept at least for 3 (three) years.*

(iii) *AAS-6 has a purpose to Establish Standards to form procedures to be followed to have an understanding of the Accounting and Internal Control system.*

(2 Marks each, November, 2008)

Answer

(i) This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

(ii) **False:** As per SA 230 on "Audit Documentation", the retention period for audit working papers 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 .

(iii) This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

Question 28

As an Auditor how would you react to the following situation/comment?

The Central Government sanctioned ₹ 20 lakh as Grant to a Hospital for the purchase of certain equipments and paid ₹ 10 lakh as advance. The hospital took ₹ 10 lakh as income in the Profit and Loss account for the year. *(6 Marks, November, 2008)*

Answer

Accounting for Government Grants: As per AS-12 "Accounting for Government Grants", government grant received for specific asset should be treated in either of the following way:

(i) Grant related to depreciable asset is treated as deferred income, which is recognized as revenue in the Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset.

OR

(ii) Grant to be shown as a deduction from gross value of the asset concerned in arriving at its book value and depreciation is charged on reduced value of fixed asset.

In the view of the above, the accounting treatment done by the hospital is not justified. The hospital has treated the grant as revenue item by taking it to the Statement of Profit and Loss and has distorted the Statement of Profit and Loss by treating the capital item as revenue. The auditor should accordingly qualify the report.

Question 29

Discuss in brief AAS-10 "using the work of another Auditor". *(5 Marks, November, 2008)*

Answer

This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

Question 30

State with reasons (in short) whether the following statements are True or False:

(i) Procedural error arises as a result of transactions having been recorded in a fundamentally incorrect manner.

(ii) AAS-24 deals with responsibility of the auditor of the service organisation.

(iii) For the purpose of AAS-10 "Principal Auditor" means the partner of the firm signing the Audit report.

(iv) An expert for the purpose of AAS-9 is a person, firm or association of persons possessing special skill, knowledge and experience in auditing.(2 Marks each, May, 2008)

Answer

(i) False: Procedural error arises when there is error in implementation of the procedure. If transaction has been recorded in a fundamentally incorrect manner it will result in error of principle.

(ii) This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

(iii) This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

(iv) This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

Question 31

As an auditor how would you react to the following situations/comments?

(i) Director (Finance) of KK Ltd. informed their newly appointed statutory auditor that they have sound Internal control system implemented by a renowned professional firm and he is satisfied with its effectiveness and functioning and therefore, the statutory auditor should concentrate on verifying only the routine books and financial statements.

(8 Marks, May, 2008)

(ii) TT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. It's production head, an expert, have also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. (6 Marks, May, 2008)

(iii) PP Ltd., a garment exporter, asked their Internal auditor, a practicing chartered accountant, to conduct physical verification of the year end inventory and the report of such verification was handed over to the statutory auditor for their view and use. Can Statutory auditor rely on such report? (6 Marks, May, 2008)

Answer

(i) **As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"**, the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.

The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

The report of the auditor is based on his examination of financial statements and the underlying documents and evidences. It is for the auditor to decide based on his evaluation of the internal control as to its existence and effectiveness. The nature, timing and extent of audit procedure are based on such evaluation.

In the instant case, management has no right to guide and place any restriction on the work of the auditor as it would amount to restriction on the scope of the audit. The auditor should ask the management not to impose such restriction on his scope of the audit that impairs his ability to examine and express an opinion and if the management does not agrees, he should issue a qualified opinion or disclaimer, as appropriate.

(ii) **As per SA 570 on "Going Concern"**, it is the responsibility of the Auditor to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

In the instant case, TT ltd. has suffered continuous losses and having negative net worth also. Besides, its production head have also left the company resulting in steep fall in production. Thus there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion.

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

(iii) **As per SA 610 "Using the Work of Internal Auditors"**, while determining whether the work of the internal auditors is likely to be adequate for the purpose of the audit, the external auditor shall evaluate: the objectivity of the internal audit function; technical competence of the internal auditors; whether the work of the internal auditors is likely to be carried out with due professional care; and whether there is likely to be effective communication between the internal auditors and the external auditor. To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether the internal auditors have adequate technical training and proficiency; work was properly supervised, reviewed and documented; any reports prepared are consistent with the results of the work performed etc.

In the instant case, the statutory auditor should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The ultimate responsibility to express opinion on the financial statement is that of the statutory auditor.

Question 32

What does AAS-3 say about utility, ownership, custody and retention of working papers?

(4 Marks, May, 2008)

Answer

This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

Question 33

What is the importance of having the accounts audited by an independent auditor?

(5 Marks, May, 2008)

Answer

Advantages of having the accounts audited by an independent auditor are:-

(i) It safeguards the financial interest of persons not associated with the management like partners or shareholders.

(ii) It acts as a moral check on the employees from committing fraud.

(iii) It is helpful in settling tax liability, negotiations for loans and for determining purchase consideration for sale/merger.

(iv) It is also helpful in settling trade or labour disputes for higher wages/bonus.

(v) It helps in detection and minimizing wastages and losses.

(vi) It ensures maintenance of adequate books and records, statutory register etc.

Question 34

State with reasons (in short) whether the following statements are True or False:

(i) AAS-9 is applicable when an auditor seeks legal opinion from an advocate.

(ii) If there is difference of opinion among the joint auditors with regard to any matter, majority joint auditors opinion will prevail while reporting.

(iii) If internal control is satisfactory, external evidence is more reliable than internal evidence. *(2 Marks each, November, 2007)*

Answer

(i) This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

(ii) False: As per SA 299 "Responsibility of Joint Auditors", where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

(iii) False: As per SA 330 "the Auditor's Responses to Assessed Risks", an effective control environment allows the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity.

Question 35

Comment on the following situation/statement:

Strong Ltd. holding 60%of the equity shares in Weak Ltd. purchased goods worth ₹ 50 Lakhs from Weak Ltd. during the financial year 2006-07. The Managing Director of Strong Ltd. is of the opinion that it is normal business activity and there is no need to disclose the same in the final accounts of the Company. *(6 Marks, November, 2007)*

Answer

Related Party Disclosures: As per definition given in the AS 18 " Related Party Disclosures" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Strong Ltd. is the holding company of Weak Ltd. as it holds more than 50% of the voting power of Weak Ltd. and thus should be treated as related parties as per AS-18.

According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

In the instant case since there is related party transaction the contention of Managing Director of strong Ltd is not correct and the auditor should insist to make proper disclosure as required by AS-18 and if the management refuses, the auditor should express a qualified opinion.

Question 36

State with reasons (in short) whether the following statements are True or False:

(a) As per AS-13, Investment should be classified into Current investments and Marketable investments.

(b) If the auditor believes that the concern will not continue as going concern, he should issue disclaimer of opinion.

(c) As per AAS-2, one of the objectives of the audit is to detect fraud. (2 Marks each, May, 2007)

Answer

(a) False: As per AS-13, Investments are classified into current and long term investment. Investments other than current investments are classified as long term investments, even though they may be readily marketable.

(b) False: As per SA 570 "Going Concern", if the auditor believes that the management's use of going concern assumption in the financial statements is inappropriate and the entity will not be able to continue its operation in future, the auditor should express an adverse opinion.

(c) This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

Question 37

As an auditor comment on the following situations:

(a) As an auditor of PQR Ltd. you have asked your audit assistant to draw the audit programme. The assistant drew up the audit programme without going through the monthly report of the Internal Auditor on the plea that he is a Chartered Accountant and have found no serious irregularities and internal control system is running perfectly.

(8 Marks, May, 2007)

(b) Mr. T. a Chartered Accountant, was first time appointed the Auditor of XYZ Ltd. Mr. T. carried the audit procedure for verifying the opening balances only, but not the previous year's accounting policies as it is not needed. (6 Marks, May, 2007)

(c) Mr. K. auditor of ABC Ltd. Is of the opinion that "Auditing and Assurance Standards" are meant only for references and it is not necessary to follow such Auditing and Assurance Standards. (6 Marks, May, 2007)

Answer

(a) Professional Judgment in Planning and Performing the Audit of Financial Statements: The contention of the audit assistant is not valid and contrary to the view and guidelines given in SA 200.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. He shall exercise professional judgment in planning and performing an audit of financial statements. Professional skepticism includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, conditions that may indicate possible fraud, circumstances that suggest the need for audit procedures in addition to those required by the SAs. Professional skepticism is necessary to the critical assessment of audit evidence which includes questioning contradictory audit evidence, and the reliability of documents; and responses to inquiries, and other information obtained from management and those charged with governance.

The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. .

In the instant case the Auditor has not exercised the professional judgment in planning and performing the audit of financial statements.

Reliance based on position of the person and blindly accepting the soundness of the internal control violates the basic principles.

Only by evaluation the auditor will know whether the internal audit and related internal control is effective or not.

(b) **Initial Audit Engagements:** Contention of Mr. T, the auditor, is not correct and contrary to the SA 510 on "Initial Audit Engagements – Opening Balances".

As per the said SA it is the duty of the auditor to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements; and appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Hence, in view of the above guidelines of SA 510, Mr. T should verify the accounting policies also to ensure its consistency.

(c) This question is redundant in view of latest Engagement and Quality Control Standards came into force.

Question 38

As an Auditor, comment on the following situations/statements:

(a) SMT Enterprises entered into a contract for sale of its goods worth ₹ 24 lacs with ST Ltd. The goods were inspected, approved and finalised by the inspection team of ST Ltd. ST

Ltd. made the whole payment of ₹ 24 lacs. However, it requested SMT Enterprises to dispatch the goods in six equal monthly instalments from October, 2005 to March, 2006. In the month of January, 2006, due to natural calamity, ST Ltd. informed SMT Enterprises to stop dispatches of the remaining three instalments until further notice. At the time of finalising its accounts for the financial year 2005-06, SMT Enterprises booked sales amounting to ₹ 12 lacs and showed remaining ₹ 12 lacs as Advance Against Sales.

(5 Marks, November, 2006)

(b) X Ltd. had a major break down in its plant in the month of February, 2006. In the month of March, 2006 it entered into an agreement with an engineering firm for the purpose of repairing its plant for a consideration of ₹ 180 lacs. The engineering firm started the repairing work in the month of April, 2006 and completed it in the same month. X Ltd. made the provision for said expenditure on repairs in its books of account for the financial year 2005-06 on the plea that the event of break down leading to repair expenditure had taken place in the financial year 2005-06, binding contract for repairs was entered into during the financial year 2005-06 and repair work was also completed before the financial statements were approved by the Board of Directors of the company. (5 Marks, November, 2006)

(c) The management tells you that WIP is not valued since it is difficult to know the same in view of multiple processes involved and in any case opening and closing WIP would be more or less the same. (4 Marks, November, 2006)

Answer

(a) Revenue Recognition (AS-9): Revenue from sales can be recognised only if the following conditions are fulfilled:

(i) The seller of goods has transferred to the buyer, the property in the goods for a price and all significant risks and rewards of ownership have been transferred to a degree usually associated with ownership and

(ii) There is no significant uncertainty exists regarding the amount of consideration that will be derived from the sale of the goods.

In the light of above two conditions in the given case SMT Enterprise had transferred the property in the goods at an agreed price and all significant risks and rewards. Thus sale is fully completed. Mere postponement of delivery until further notice as requested by ST LTD., does not alter the status of sale.

As the sale is completed, entire amount of ₹ 24 lakhs should be recognized lacs in the F.Y. 2005-2006 only. SMT Enterprise recognising only ₹ 12 lacs sales in F. Y. 2005-2006 is not correct.

(b) Provision for Expenditure on Repairs (AS 29): As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. A provision is a liability which can be measured only by using a substantial degree of estimation.

In the instant case, though the event of break down and binding contract for repairs was entered into F. Y. 2005-06, but as the Engineering firm has not started performing the work of repair until the date of balance sheet, liability can not be said to have been arisen as on the date of balance sheet.

In view of the above, provision made by X Ltd. for expenditure on repairs in its books of account of F.Y. 2005-06, for repair work to be done in the next F.Y. 2006-07 is absolutely wrong, as there was no obligation. The auditor should bring this wrong provision to the notice of the authorities of X Ltd. and report accordingly.

(c) Valuation of WIP: AS 2 deals with the principles and methods for determining the value at which inventories should be carried in the financial statements. Thus, items hold in the process of production is included in the definition of inventory.

Work in Process (WIP) is normally, valued by taking the basic cost of materials, labour and proportionate factory overhead incurred upto the stage of completion. In view of the above, the argument that the value of opening and closing WIP is more or less same is not tenable as the cost of material, labour and overhead might be different and accordingly, arriving at the different valuation of opening and closing WIP is possible.

In the given case, the management should have determined the stage of completion of the production and valued the work in process accordingly.

Further, the auditor should ensure that physical verification of inventory has been conducted at reasonable intervals by the management; are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported; whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.

Question 39

RT Ltd. Received ₹ 50 lacs as grant from the State Government towards the part cost of a specific machinery. The company credited the above sum of ₹ 50 lacs as income in its Profit and Loss Account for the year. What are your views on the accounting treatment of the above receipt of ₹ 50 lacs? *(4 Marks, November, 2006)*

Answer

Accounting treatment of Government Grants: As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. There are two method of accounting. Under one method, the grant is shown as a deduction from the gross value of the assets concerned in arriving at its book value. Depreciation is charged on reduced value of fixed assets. Under other method, grants related to depreciable assets are treated as deferred income which is recognized in the Profit &Loss account on a systematic and rational basis over the useful life of the assets.

In the given question, accounting treatment of grant received towards part cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report.

Question 40

What are the basic principles governing an audit as laid down in AAS 1? Explain in brief.

(10 Marks, November, 2006)

Answer

The question is redundant in view of latest Engagement and Quality Control Standards.

Question 41

How the work of an expert should be evaluated before accepting the same as an Audit evidence? *(8 Marks, November, 2006)*

Answer

Evaluation of work of an expert: SA 620, "Using the Work of an Auditor's Expert" discusses the auditors responsibility in relation to and the procedure the auditor should consider in using the work of an expert as audit evidence. When the auditor delegates work or uses work performed by experts, he will continue to be responsible for forming and expressing his opinion on the financial information. In such cases, the auditor should obtain reasonable assurance that work performed by experts is adequate for his purpose. When the auditor intends to use the work of an expert, he should evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

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

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

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

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

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

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

Question 42

Write short notes on the following:

(i) Current Investments.

(ii) First in First out (FIFO) method.

(iii) Accounting Estimates. *(4 Marks each, November, 2006)*

Answer

(i) **Current Investment:** It means an Investment that is by nature readily saleable & realisable and is intended to be held for not more than one year, from the date on which such investment is made.

As per AS 13, the valuation of current investment at lower of cost and fair value provides a prudent method of determining the carrying amount to be stated in the balance sheet.

Any reduction to fair value and any reversal of such reduction are to be included in the Profit & Loss Account. It is essential to disclose in financial statement the accounting policies for determination of carrying amount of investment and income therefrom. Disclosure of profit/loss on disposal of current investment and changes in carrying amount of investment is also necessary.

(ii) **First-In-First-Out (FIFO) Method:** It is a cost formula used in assigning the cost to inventories which are ordinarily interchangeable. The FIFO formula assumes that the items of inventories which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those which have been most recently purchased or produced. This method of valuation of inventory is not applied where items of inventory are not ordinarily interchangeable.

(iii) **Accounting Estimates:** According to the SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure" accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. SA 540 addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific.

Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.

- Fair value accounting estimates for derivative financial instruments not publicly traded.

Additional examples of accounting estimates are:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

Question 43

As an auditor, comment on the following situation/statement:

The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately. *(5 Marks, May, 2006)*

Answer

Disclosure of Surplus on Sale of Investments: AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changing in Accounting Policies" prescribes the classification and disclosure of items in the statement on profit and loss account. AS 5 requires separate disclosure of prior period item, extraordinary items, etc. distinctly so as to reflect the financial position of enterprise for better understanding of users of financial statements. In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Accordingly the auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.

Question 44

What are the meaning and purposes of Sampling? Explain in the light of AAS-15, Audit Sampling. *(8 Marks, May, 2006)*

Answer

The question is redundant in view of latest Engagement and Quality Control Standards.

Question 45

Write short notes on "Initial Engagements". *(4 Marks, May, 2006)*

Answer

Initial Engagement: SA 510 "Initial Audit Engagements – Opening Balances", requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(i) the closing balances of the preceding period have been correctly brought forward to the current period;

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

(iii) appropriate accounting policies are consistently applied.

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

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

Question 46

As an auditor, comment on the following:

(a) M/s Bonafide Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2004-05 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2003-04 was less charged by ₹ 75 lacs on account of arithmetical error on the part of Insurance Company. M/s Bonafide Ltd. paid the said sum of ₹ 75 lacs during the accounting year 2004-05 by debiting the same to Prior Period Expenses. (5 Marks, November, 2005)

(b) As on 31.3.2005, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide satisfactory after-sales services in relation to the software purchased from it. Before finalisation of the accounts for the year ended 31.3.2005 (the accounts were finalised on 14th June, 2005), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 31.3.2005, which, it says, will be reversed in the next year.

(5 Marks, November, 2005)

Answer

(a) Prior Period Expenses: Accounting Standard 5 defines the prior period items as income or expenses which arise in the current period as a result of errors or omission in the preparation of the financial statements of one or more prior period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts or oversight. In this case, there has been arithmetical mistake of ₹ 75 lacs in computing the amount of premium.

Though in this case there was no error or omission on the part of M/s Bonafide Ltd. and the error was on the part of the Insurance Company. But it is the management of the enterprise which is responsible for preparation of financial statements. Thus, the expenditure of ₹ 75 lacs pertains to prior period and to be debited to Prior Period Expenses. Therefore, the accounting treatment accorded by the management is appropriate. The auditor should, however, ensure that the nature of mistake, i.e., insurance premium as well as amount of ₹ 75 lacs has been disclosed separately in such a manner that its impact on the current profit or loss can be perceived.

(b) Events Occurring After the Balance Sheet Date: As per facts of the case on 31.3.2005, there was a claim against the company for damages by a customer for not providing after sales service. It is a condition prevailing as on the date of balance sheet. Part I of Schedule III to the Companies Act, 2013 requires disclosure of claims against company not acknowledged as debt as a footnote under caption contingent liability if the same had not been provided for in the balance sheet. However, as on that date, the company had provided for the contingent liability perhaps in view of expectation that such a claim may crystallize as liability against it. The winning of the case by the company in its favour (before the accounts were approved) after the date of the balance sheet constitutes additional evidence that will be of help in deciding the treatment of the matter in the accounts as per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date". However, no provision would be needed as the case had been won by the company, since confirmed by subsequent event happening after the balance sheet date. The disclosure of facts of the case is, however, necessary with a view to keeping users of financial statements informed about the nature of event as well as the fact that no provision is necessary.

Question 47

Give your comments on the following:

Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2004-05. The closing stock of the company as on 31.3.2004 amounting to ₹ 100 lacs continued as it is and became closing stock as on 31.3.2005. The auditors of the company propose to exclude from their audit programme the audit of closing stock of ₹ 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. (5 Marks, November, 2005)

Answer

Verification of Inventory: SA 510 "Initial Audit Engagements – Opening Balances", requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(i) the closing balances of the preceding period have been correctly brought forward to the current period;

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

(iii) appropriate accounting policies are consistently applied.

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

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

Question 48

(a) Under what circumstances change in accounting policies is permissible?

(b) What are the inherent limitations of audit? *(8 Marks each, November, 2005)*

Answer

(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) Inherent limitations of Audit: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from:

(i) The Nature of Financial Reporting: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.

(ii) The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(iii) Timeliness of Financial Reporting and the Balance between Benefit and Cost: The relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

(iv) Other Matters that Affect the Limitations of an Audit: In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

Question 49

Write short notes on the following:

(a) General Purpose Financial Statements.

(b) Going Concern Concept. *(4 Marks each, November, 2005)*

Answer

(a) General Purpose Financial Statements: As defined in SA 700-"Forming an Opinion and Reporting on Financial Statements", General purpose financial statements are Financial statements prepared in accordance with a general purpose framework.

A financial reporting framework designed to meet the common financial information needs of a wide range of users is called General purpose framework.

The term "General Purpose Financial Statements" normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report. Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Accounting Standards are applicable to all General Purpose Financial Statements.

(b) Going Concern Concept: AS 1, "Disclosure of Accounting Policies", lays down that the "Going Concern", is one of the fundamental accounting assumption underlying financial statements. This Going Concern concept envisages that the entity will continue for the foreseeable future. Accounts are prepared on this concept unless there are indication that going concern concept is not holding good for a particular entity. On account of this basic concept of going concern, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. If this assumption is unjustified, the entity may not be able to realise its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. AS 1, "Disclosure of Accounting Policies", also requires that no specific disclosure is required in case the same has been followed in the preparation of financial statements. In case this assumption is not followed, the fact should be disclosed.

SA 570 "Going Concern", establishes standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

Question 50

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

(a) You are the Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 20th July. The Sales Ledger balance at 31st March was ₹ 95,000. By 20th July ₹ 65,000 only had been received against this amount as full and final payment. *(4 Marks, November, 2004)*

(b) AAS Ltd. Is procuring the packing materials from M/s XY and Co., a partnership firm consisting of Mr. X and Mr. Y. Mr. Y is the Managing Director of AAS Ltd. The total value of purchases made from XY and Co. by AAS Ltd. During the year 2003-04 had been ₹ 38 lakhs. *(4 Marks, November, 2004)*

(c) A Computerised Machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that they would use the machinery equally and show in their Balance Sheets, 50% of the value of the machinery and charge 50% of the depreciation in their respective books of accounts. *(4 Marks, November, 2004)*

Answer

(a) Consideration of Subsequent Events: SA 560 "Subsequent Events" requires that the auditors should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements. AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" also classifies an adjusting event which provides further evidence of conditions that existed at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of trade receivables as also the realisability aspect. The auditor's duties in respect of trade receivables remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from trade receivables. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31. Accordingly, the auditor would have now to see that in respect of outstanding amount of ₹ 30,000, whether the amount of provision needs any revision.

(b) Transactions with Related Parties: SA 550 "Related Parties" establishes standards on auditor's responsibilities and audit procedures regarding related party transactions. In this case, the related party relationship is absolutely clear and accordingly the auditor must examine that the disclosure requirements as laid down in AS 18, "Related Party Disclosures" has been followed, as Managing Director is the interested party.

Further, the auditor has to ensure compliance of the Companies Act 2013 requirements, viz., transaction required to be entered into the Register pursuant to section 189 of the Companies Act, 2013 and having regard to the fact whether such prices were reasonable or not.

Accordingly, the auditor has to ensure that the AAS Ltd. has made proper disclosures in financial statements.

(c) Joint Assets: AS 10, "Accounting for Fixed Assets", issued by the Institute, prescribes that in case of fixed assets owned jointly by enterprises, the extent of the entity's share in such assets, and the proportion in the original cost, accumulated depreciation and written down value should be stated in the Balance Sheet. Accordingly, the treatment followed by the companies reflecting 50% of the value of the machinery and changing 50% depreciation in their respective books of account is proper. However, such jointly owned assets should be indicated separately in the Fixed Assets Register maintained by the company.

(Note: Alternatively, AS 10 also recommends that the pro-rata cost of such jointly owned assets may be grouped together with similar fully owned assets and appropriate disclosure of the same should be made.)

Question 51

What are the auditor's responsibilities for detection of Frauds and Errors?

(8 Marks, November, 2004)

Answer

Auditor's Responsibilities for Detection of Fraud and Error: As per SA 240 "The Auditor's Responsibilities relating to fraud in an audit of Financial Statements", an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:

(a) failure to obtain reasonable assurance,

(b) inadequate planning, performance or judgment,

(c) absence of professional competence and due care, or,

(d) failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

In planning and performing his examination the auditor should take into consideration the risk of material misstatement of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error, which has occurred in the reporting period, and modify his audit procedures, if necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a fraud, the same should be disclosed in the financial statement. If adequate disclosure is not made, there should be a suitable disclosure in his audit report.

Further, as per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 52

What are accounting estimates according to Auditing and Assurance Standards -18 (AAS-18)? Give examples. *(8 Marks, November, 2004)*

Answer

The question is redundant in view of latest Engagement and Quality Control Standards.

Question 53

State briefly the qualities of Auditors. *(4 Marks, November, 2004)*

Answer

Qualities of Auditors: The auditor should possess specific knowledge of accountancy, auditing, taxation, etc. which are acquired by him during the course of his theoretical education.

The auditor should also have sufficient knowledge of general principles of law of contracts, partnership; specific statutes and provisions applicable, e.g. Companies Act, 2013, Co-operative Societies Act, etc.; client's nature of business and its peculiar features. Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities such as, tact; caution; firmness; good temper; judgement; patience; clear headedness and commonsense; reliability and trust, etc.

In short, all those personal qualities required to make a good person contribute to the making of a good auditor. In addition, the auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, SA 200 mentions integrity, objectivity and independence as one of the basic principles.

Auditing is a profession, calling for wide variety of knowledge to which no one has yet set a limit, the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

Question 54

Write short notes on "Analytical review". *(4 Marks, November, 2004)*

Answer

Analytical Review: SA 500 on Audit Evidence defines analytical review as those tests of details which consist of studying significant ratios and trends and investigating unusual fluctuation and items. Thus, analytical reviews are substantive audit procedure with the help of which auditor can perform tests of details in more efficient and effective manner. Therefore, analytical reviews are nothing best analytical review procedures which have been considered at length in SA 520 on "Analytical Procedures". According to SA 520, analytical procedures include the consideration of comparisons of the entity's financial information with, for example, comparable information for prior periods or anticipated results of the entity, such as budgets or forecasts. Consideration of relationships among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages, between financial information and relevant non-financial information, such as payroll costs to number of employees also constitute analytical review procedures.

Analytical review procedures are used for the following purposes:

(a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

(b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and

(c) as an overall review of the financial statements in the final review stage of the audit.

The extent of reliance that the auditor places on the results of analytical review procedures depends on materiality of the items involved, assessment of inherent and control risks, etc.

Question 55

Mention any twelve title of Statements on AASs and the date from which it comes into force.

(6 Marks, May, 2004)

Answer

The question is redundant in view of latest Engagement and Quality Control Standards.

2

Basic Concepts in Auditing

Question 1

Discuss "The reliability of audit evidence is influenced by its source, nature and circumstances under which it is obtained". *(5 Marks, November, 2013)*

Or

Write short notes on Reliability of Audit Evidence.

(4 Marks, November, 2011, 5 Marks, May, 2008)

Answer

Reliability of Audit Evidence: 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:

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

(ii) 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.

(iii) 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).

(iv) 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).

(v) 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.

Question 2

State with reason (in short) whether the following statement is correct or incorrect:

"Financial Statements should show "True and correct" view of the affairs of the entity".

(2 Marks, November, 2013)

Answer

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.

Question 3

Discuss "Inquiry is one of the audit procedure to obtain audit evidence". (5 Marks, May, 2013)

Answer

Inquiry – Audit Procedure to obtain Audit Evidence: Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

Question 4

Comment "Compliance procedures are tests designed to obtain audit evidence as to completeness, accuracy and validity of data produced by accounting system". (2 Marks, May, 2013)

Answer

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Here auditor is concerned with assertions that the control exists and is operating effectively.

Question 5

Write short notes on Assertion about balance at the end of the reporting period.

(4 Marks, May, 2013)

Answer

Assertions about account balances at the end of the reporting period: Assertions about account balances at the period end are:

(i) Existence—assets, liabilities, and equity interests exist.

(ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Question 6

(a) Explain the concept of "True and Fair" view. (6 Marks, November, 2012)

Or

Discuss the concept of "True and Fair". (8 Marks, May, 2005)

(b) Mention the areas in which differing accounting policies are encountered and how that would be disclosed? (10 Marks, November, 2012)

Answer

(a) Concept of "True and Fair": The concept of "true and fair" is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verifying that all assets and liabilities, incomes and expenses are stated at the amounts which are in accordance with accounting principles and policies, and no material item has been omitted.

(i) As per section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.

    Provided that the items contained in such financial statements shall be in accordance with the accounting standards.

    Provided further that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

    Provided also that the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—-

    (a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

    (b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

    (c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

    (d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

(ii) At every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year.

(iii) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2).

Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed.

Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.

Explanation.—For the purposes of this sub-section, the word "subsidiary" shall include associate company and joint venture.

(iv) The provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements referred to in sub-section (3).

(v) Without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

(vi) The Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of this section or the rules made thereunder, if it is considered necessary to grant such exemption in the public interest and any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

(vii) If a company contravenes the provisions of this section, the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Explanation.—For the purposes of this section, except where the context otherwise requires, any reference to the financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under this Act.

(b) The areas in which different accounting policies may be encountered are:-

(i) Method of depreciation, depletion and amortization-Straight Line Method, Written Down Value method.

(ii) Valuation of inventories – FIFO, LIFO, weighted average etc.

(iii) Treatment of goodwill – write off, retain.

(iv) Valuation of investment – at cost, market or net realizable value etc.

(v) Treatment of retirement benefits-Actuarial, funded through trust, insurance policy etc.

(vi) Valuation of fixed assets-historical cost, revaluation price, exchange fluctuation etc.

Note: (The above list is not exhaustive. There may be other examples as well.)

Disclosure of Accounting Policies: The purpose of AS-1 is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

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

Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Question 7

Explain "Going Concern" assumption with reference to SA. State some financial events or conditions that may cast doubt about going concern assumption. (8 Marks, May, 2012)

Answer

Going Concern Assumption: SA 570, “Going Concern” deals with the auditor’s responsibility in the audit of financial statements with respect to management’s use of the going concern assumption in the preparation and presentation of the financial statements.

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis is relevant. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

Financial Events or Conditions that may cast doubt about Going Concern Assumption: The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption.

(i) Net liability or net current liability position.

(ii) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.

(iii) Indications of withdrawal of financial support by creditors.

(iv) Negative operating cash flows indicated by historical or prospective financial statements.

(v) Adverse key financial ratios.

(vi) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.

(vii) Arrears or discontinuance of dividends.

(viii) Inability to pay creditors on due dates.

(ix) Inability to comply with the terms of loan agreements.

(x) Change from credit to cash-on-delivery transactions with suppliers.

(xi) Inability to obtain financing for essential new product development or other essential investments.

Question 8

Explain various methods to obtain audit evidence. *(8 Marks, May, 2011)*

Answer

Methods to obtain Audit Evidence: The auditor obtains evidence in performing compliance and substantive procedures by one or more of the following methods:-

(i) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

(ii) **Observation:** Observation consists of looking at a process **or** procedure being performed by the others. For example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

(iv) **Recalculation:** Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.

(v) **Reperformance**: It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

(vi) **Analytical Procedure**: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) **Inquiry:** Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Question 9

What do you mean by the term 'Sufficient Appropriate Audit Evidence'? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence.

(6 Marks, Nov 2010)

Answer

Meaning of sufficient appropriate audit evidence: The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

SA 500 on 'Audit Evidence' further expounds this concept. According to it, the sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. Further, SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

In general the various factors which may influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under:

(i) Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.

(ii) The materiality of the item.

(iii) The experience gained during previous audits.

(iv) The results of auditing procedures, including fraud and errors which may have been found.

(v) The type of information available.

(vi) The trend indicated by accounting ratios and analysis.

Question 10

Write short notes on "Substantive Procedures". *(5 Marks, May, 2010, 4 Marks, May, 2004)*

Answer

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.

Question 11

Explain concept of materiality and factors which act as guiding factors to this concept.

(6 Marks, November, 2009)

Answer

Concept of materiality: SA 320 "Materiality in Planning and Performing an Audit", establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements. Financial statements materially affect if such statement is erroneously stated or omitted to be stated there in and economic decision of the users taken on the basis of such information is influenced by such misstatements or omissions.

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

The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not.

There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

Factors to be considered for determining materiality

(i) Item of materiality may be determined individually or in aggregate.

(ii) The materiality depends on the regulatory or legal considerations.

(iii) Materiality is not often reckoned with respect to quantitative details above. It has qualitative dimensions as well.

(iv) Even insignificant items in terms of quality may be material in special circumstances.

(v) Sometimes the materiality of an item in terms of quantity is described in law itself.

(vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

Question 12

In auditing, the auditor checks the specific assertions of the items appearing in the financial statements and opines about the overall assertions they signify. Explain specific assertions and overall assertions in this context. *(10 Marks, June, 2009)*

Answer

Auditor checks specific assertions that the items of financial statements portray and also gives his opinion in the form of overall assertion in respect of financial statements taken as a whole.

The **specific assertions** are –

(a) Existence – That the asset or liability exists at a given date.

(b) Rights and obligations – The asset is a right of the entity and the liability is an obligation of the entity at a given date.

(c) Occurrence – That a transaction or event has occurred which pertains to the entity

(d) Completeness – There are no unrecorded asset/liabilities or transactions

(e) Valuation – An asset or liability is recorded in the proper amount and recorded at appropriate carrying value.

(f) Measurement – A transaction is recorded in the proper amount and revenue or expenses is allocated to proper period.

(g) Presentation – An item is disclosed, classified and described in accordance with accounting policies and legal requirements.

The **overall assertions** opined by the auditor about the financial statements are:

(a) The Statement of Profit and Loss give a true and fair view of the results – profit or loss for the period ended on the last date of the accounting period.

(b) The balance sheet gives a true and fair view of the status or financial position of the entity as on the last date of the accounting period.

Question 13

Distinguish between Internal evidence and External evidence. *(4 Marks, November, 2008)*

Answer

Types of Audit Evidence: There are two types of Audit evidence i.e. 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.

Question 14

State with reason (in short) whether the following statement is correct or incorrect:

"Compliance procedures are tests designed to obtain audit evidence as to completeness, accuracy and validity of the data produced by accounting system". *(2 Marks, May, 2008)*

Answer

False: Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Here auditor is concerned with assertions that the control exists and is operating effectively.

Question 15

What are the various assertions an auditor is concerned with while obtaining audit evidence from substantive procedure? *(6 Marks, May, 2008)*

Answer

Assertion to be considered while obtaining Audit Evidence: In obtaining audit evidence from substantive procedures, the auditor concerned with the following assertions:

(i) **Existence -** that an assets or liability exists at a given date.

(ii) **Rights and obligations -** that an asset is a right of the entity and a liability is an obligation at a given date.

(iii) **Occurrence -** that a transaction or event took place which pertains to the entity.

(iv) **Completeness -** that there are no unrecorded assets, liabilities or transaction.

(v) **Valuation -** that an asset or liability is recorded at an appropriate carrying value.

(vi) **Measurement -** that a transaction is recorded in the proper amount and revenue or expenses are allocated to proper period.

(vii) **Presentation & disclosure -** that an item is disclosed, classified and described in accordance with recognized accounting policies, practices and statutory requirements.

Question 16

State with reason (in short) whether the following statement is correct or incorrect:

"One of the techniques used for gathering evidence is substantial review".

(2 Marks, November, 2007)

Answer

False: One of the techniques used for obtaining evidence is analytical review procedure which consists of studying significant ratios and trends. (SA 500 "Audit Evidence")

Question 17

State any ten areas in which different accounting policies may be encountered.

(5 Marks, November, 2007)

Answer

Areas in which different accounting policies may be encountered are:-

(i) Method of depreciation, depletion and amortization-Straight Line Method, Written Down Value method.

(ii) Valuation of inventories – FIFO, LIFO, weighted average etc.

(iii) Treatment of goodwill – write off, retain.

(iv) Valuation of investment –at cost, market or net realizable value etc.

(v) Treatment of retirement benefits-Actuarial, funded through trust, insurance policy etc.

(vi) Valuation of fixed assets-historical cost, revaluation price, exchange fluctuation etc.

Note: (The above list is not exhaustive. There may be other examples as well.)

Question 18

State with reason (in short) whether the following statement is true or false:

"An auditor is considered to lack independence, if the partner of the audit firm owns the building in which the client's business is situated". (2 Marks, May, 2007)

Answer

False: According to the Guidance Note issued by the ICAI on "Independence of Auditors", "Independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest." In this case of Renting of building to the client does not affect the independence.

Question 19

What are the obvious assertions in the following items appearing in the Financial Statements?

(i) Profit and Loss Statement

Travelling Expenditure ₹ 50,000

(ii) Balance Sheet

Debtors ₹ 2,00,000 (2 Marks each, November, 2005)

Answer

Assertion for the Items appearing in Financial Statements:

(i) Travelling Expenditure: ₹ 50,000

- Expenditure has been actually incurred for the purpose of travelling.
- Travelling has been undertaken during the year under consideration.
- Total amount of expenditure incurred is ₹ 50,000 during the year.
- It has been treated as revenue expenditure and charged to Statement of Profit and Loss.

(ii) Debtors: ₹ 2,00,000

- These include all sales transaction occurred during the year.
- These have been recorded properly and occurred during the year
- These constitute assets of the entity.
- These have been shown at proper value, i.e. after showing the deduction on account of provision for bad and doubtful debts.

Question 20

Explain with reference to the relevant Auditing and Assurance Standards, Appropriateness of going concern assumption? (5 Marks, May, 2005)

Answer

Appropriateness of Going Concern Assumption: As per SA 570 "Going Concern", in some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity. However, the auditor should consider the risk that the going concern assumption may no longer be appropriate. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by trade payables.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay trade payables on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

  The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

  The risk assessment procedures required by paragraph 10 of the SA help the auditor to determine whether management's use of the going concern assumption is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

Question 21

The auditor of a limited company has given a clean report on the financial statement on the basis of Xerox copies of the books of accounts, Vouchers and other records which were taken away by the Income-tax Department in search under section 132 of the I.T. Act, 1961.

(5 Marks, November, 2004)

Answer

As per SA 500 on "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

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

(ii) 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.

(iii) 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).

(iv) 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).

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

Applying the above, the degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be considerably increased if the xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly. Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

3
Preparation for an Audit

Question 1

Discuss the following:

(a) Despite of several disadvantages, audit programme is required to start an audit.

(5 Marks, November, 2013)

(b) Is surprised checks desirable in audit, if so give important recommendations.

(5 Marks, May, 2013)

Answer

(a) 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) Need of Surprise Checks: The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit.

The following are the important recommendations:

(i) Surprise checks should be considered as a desirable part of each audit.

(ii) The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:

(1) Verification of cash and investments.

(2) Test-verification of stores and inventories and the records relating thereto.

(3) Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.

(iii) The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

(iv) The results of the surprise checks should be communicated to the management if they reveal any weakness in the system of internal control or any fraud or error or deficiency in the maintenance of records.

(v) The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.

(vi) It is not necessary in all cases for the results of the surprise checks to be included in the auditors' report on the accounts. They should, however, be included if in the opinion of the auditor they are material and affect a true and fair view of the accounts on which he is reporting.

Question 2

State with reason (in short) whether the following statement is correct or incorrect.

Inherent and control risk, and detection risk have same meaning. (2 Marks, November, 2013)

Answer

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.

Question 3

Write short notes on the following:

(a) Importance of audit working papers. (4 Marks, November, 2013)

(b) Audit Planning & Materiality. *(4 Marks, May, 2013)*

Answer

(a) 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.

(b) Audit Planning and Materiality: Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. When planning the audit, the auditor considers what would make the financial information materially misstated. The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. It may be noted that the auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as against at the time of evaluating the results of audit procedures.

Question 4

What is continuous audit and what are the precautions which should be taken to avoid the disadvantages of continuous audit? *(8 Marks May 2013)*

Answer

Continuous audit: A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client the whole year round or when for this purpose the staff attends at intervals, fixed or otherwise, during the currency of the financial period.

The disadvantages of a continuous audit can be avoided if the following precautions are taken:

(i) During the course of each visit, work should be completed upto a definite stage so as to avoid loose ends.

(ii) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.

(iii) The visits should be at irregular intervals of time so that the client's staff may not in advance know the exact date when the audit would be resumed and thus may be able to prepare themselves in advance for the same.

(iv) The nominal accounts should be checked only at the time of final closing.

(v) The client's staff should be instructed not to alter or correct audited figures. The auditor should also device a special form of ticks for being placed against figures which have been altered and neither its purpose nor significance should be disclosed to the client's staff.

Question 5

What are the audit working papers? Discuss various contents of current file.

(8 Marks, November, 2012)

Answer

Audit Working Papers: Working papers are papers prepared and obtained by the auditor and retained by him, in connection with the performance of his audit. Working papers are the property of the auditor. As per SA 230 "Audit Documentation" refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used).

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

Current Audit file: The current file normally includes:

(i) Correspondence relating to acceptance of annual reappointment.

(ii) Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.

(iii) Evidence of the planning process of the audit and audit programme.

(iv) Analysis of transactions and balances.

(v) A record of the nature, timing and extent of auditing procedures performed and the results of such procedures.

(vi) Evidence that the work performed by assistants was supervised and reviewed.

(vii) Copies of communications with other auditors, experts and other third parties.

(viii) Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.

(ix) Letters of representation or confirmation received from the client.

(x) Conclusions reached by the auditor concerning significant aspects of the audit.

(xi) Copies of the financial information being reported on and the related audit reports.

Question 6

Write short notes on the following:

(a) Initial Engagements. *(4 Marks, May, 2012)*

(b) Disadvantages of the use of an audit programme. *(4 Marks, May, 2012)*

(c) Audit Techniques. *(4 Marks, May, 2012 5 Marks, May, 2007)*

(d) Simple random sampling. *(4 Marks, May, 2012)*

Answer

(a) Initial Engagements : In conducting an initial engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements; and appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

(b) Disadvantages of the use of an Audit Programme: There are some disadvantages in the use of audit programmes but most of these can be removed by taking some steps which otherwise also contribute to the making of a good audit. The disadvantages are:

(i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

(iii) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(iv) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

(c) Audit Techniques: For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following:

(i) Posting checking

(ii) Casting checking

(iii) Physical examination and count

(iv) Confirmation

(v) Inquiry

(vi) Year-end scrutiny

(vii) Re-computation

(viii) Tracing in subsequent period

(ix) Bank Reconciliation

The two terms, procedure and techniques often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve technique of inspection and checking computation of documentary evidence.

(d) Simple random sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 5,000 to ₹ 25,000 and not in the range between ₹ 25 to ₹ 2, 50,000.

Question 7

Comment on the following:

"It is not mandatory to send a new engagement letter in recurring audit, but sometimes it becomes mandatory to send new letter". Explain those situations where new engagement letter is to be sent. *(5 Marks, November, 2011)*

Answer

Issue of Audit Engagement Letter in Recurring Audits: On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, in the following situations it is appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change in senior management or board of directors.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

Question 8

Write short notes on the following:

(a) Importance of working papers. (4 Marks, November, 2011)

(b) Advantages of statistical sampling in Auditing. (4 Marks, November, 2011, 5 Marks, May, 2008)

(c) Stratified sampling. (4 Marks, May, 2011)

Answer

(a) 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 client's 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:

(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.

(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 sample selection is more objective and is based on mathematical law of probability.

(iii) This provides a means of estimating the 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, since non-sampling errors such as processing and clerical mistake are not large.

(c) Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgement.

The reason behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

Question 9

R & M Company, a firm of Chartered Accountants, was appointed as statutory auditors of XYZ Company Ltd. Draft an engagement letter accepting the appointment as auditors.

(8 Marks, November, 2010)

Answer

Engagement Letter for accepting the appointment as an Auditor: As per the SA 210, "Agreeing the Terms of Audit Engagements", the draft of Engagement Letter is as follows:

To the Board of Directors of XYZ Company Limited

You have requested that we audit the financial statements of XYZ Company Limited, which comprise the Balance Sheet as at March 31, 2014, and the Statement of Profit and Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]1 acknowledge and understand that they have responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards.[2] This includes:

  (i) The responsibility for the preparation of financial statements on a going concern basis.

  (ii) The responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.

  (iii) The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

(b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(c) To provide us with:

  (i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

  (ii) Additional information that we may request from [management] for the purpose of the audit; and

  (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

[1] Use terminology as appropriate in the circumstances.

[2] Or, if appropriate, "For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards".

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

R & M Co.
Chartered Accountants
Firm's Registration No.
…………………………
(Signature)

Date : (Name of the Member)

Place : (Designation[3])

Acknowledged on behalf of XYZ Company by

……………………..
(Signature)
Name and Designation
Date

Question 10

Write short notes on Audit Working Papers. *(5 Marks, May, 2010)*

Answer

Audit Working Papers: The audit working papers constitute the link between the auditor's report and the client's records. SA 230 on "Audit Documentation" refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The object of Audit working papers is to provide:

(i) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

(ii) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

[3] Partner or proprietor, as the case may be.

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

(a) Assisting the engagement team to plan and perform the audit.

(b) 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 on Quality Control for an Audit of Financial Statements.

(c) Enabling the engagement team to be accountable for its work.

(d) Retaining a record of matters of continuing significance to future audits.

(e) Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.

(f) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Working papers should contain audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The auditor shall assemble the audit working papers in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. The retention period for audit working papers 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. Unless otherwise specified by law or regulation, audit working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients.

Question 11

State with reasons (in short) whether the following statements are true or false:

(i) While auditing the accounts of a company, it is obligatory that the auditor must adopt sampling technique.

(ii) The auditee firm has no right to compel the auditor to provide copies of the working papers. *(2 Marks each, November, 2009)*

Answer

(i) False: It is not obligatory that the auditor must adopt sampling technique in auditing the accounts. But he should ensure that the relevant standards on auditing have been followed. It is in the interest of the auditor if he decides to form his opinion on the basis of audit sample using standards and techniques which are widely followed and recognized.

(ii) True: Working papers are the property of the auditors. Auditee has no right to compel the auditor's firm to provide it with the copies of working papers. However, the auditors may at their discretion make portions of or extracts from their working papers available to the Auditee.

Question 12

Describe a set of instructions, which an auditor has to give to his client before the start of actual audit. *(4 Marks, November, 2009)*

Answer

Following instructions are given by the auditor to the client before the start of audit:

(i) The accounts should be totaled up and trial balance and final accounts be kept ready.

(ii) Vouchers should be serially arranged.

(iii) Schedule of trade receivables and trade payables should be prepared.

(iv) Schedule of outstanding expenses, prepaid expenses and accrued income to be kept ready.

(v) A list of bad and doubtful debts should be prepared.

(vi) Schedule of investments should be prepared.

(vii) Certified list of goods returned to be prepared.

(viii) Statement of permanent capital expenditure to be prepared.

(ix) Schedule of deferred revenue expenditures to be prepared.

(x) Names and addresses of managers and other officers should be kept ready.

Alternative answer

(i) It is the responsibility of the management to prepare the financial statements, to select and consistently apply the appropriate accounting policies

(ii) Management is responsible for the maintenance of adequate accounting records and internal controls for safeguarding assets of the company

(iii) Unrestricted access to whatever records, documentation and other information required in connection with the audit.

(iv) Management's responsibility for making judgements of estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity.

(v) Management's responsibility for preparation of the financial statements as a going concern.

Question 13

X, a Chartered Accountant was engaged by PQR & Co. Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors, which was accepted by the Company. In the course of audit of the company, the auditor was unable to obtain appropriate sufficient audit evidence regarding receivables. The client requested for a change in the terms of engagement. Offer your comments in this regard. (5 Marks, November, 2009)

Answer

Change in terms of engagement

(i) An auditor who is required to change the engagement which requires lower level of assurance before the completion of engagement should consider the appropriateness of doing so.

(ii) But when the terms of engagement are changed, both the auditor and the client should agree on the new terms.

(iii) However, the auditor should not agree to a change in terms where there is no reasonable justification for doing so.

(iv) In the instant case, the auditor was unable to obtain sufficient evidence regarding receivables. The client requested him for a change in the terms of the agreement to avoid qualified/adverse opinion. Hence there is no reasonable justification for change in the terms of engagement.

(v) Thus the auditor should not agree for change in the terms of engagement letter.

Question 14

Write short notes on "Audit risk at the account balance level and at the class of transactions level". (5 Marks, November, 2009)

Answer

Audit risk at the account balance level and at the class of transactions level

Majority of audit procedures are directed to and carried out at the account balance level and the class of transactions level. At these levels, the auditor uses professional judgment to evaluate numerous factors to assess inherent risk:

(i) Financial statement of accounts likely to be susceptible to mismanagement.

(ii) The complexity of underlying transactions which might require the use of the work of an expert.

(iii) The amount of judgment involved in determining account balances.

(iv) Susceptibility of assets to loss or misappropriation.

(v) The completion of unusual and complex transactions, particularly at or near year end.

Question 15

State with reasons (in short) whether the following statement is True or False:

"Taking management representation is a convenient, economical and equally acceptable auditing method even where the direct access by auditor to audit evidence is possible".

(2 Marks, June, 2009)

Answer

False: Where it is possible for auditor to check the transaction by himself through direct access, it is not fair for him to merely rely the management representation as prime audit evidence.

Question 16

Write short notes on "Knowledge of Client's business". (5 Marks, June, 2009)

Answer

Knowledge of client's business – As per SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", an auditor can obtain this information from:

(i) Clients annual report to shareholders

(ii) Minutes of shareholders/board of directors

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

(iv) Previous year audit working papers

(v) Discussion with client

(vi) Clients policy and procedure manual

(vii) Publications like trade journals, magazines, newspapers and

(viii) Visit to client's premises.

Question 17

State with reasons (in short) whether the following statements are True or False:

(i) Management Certificate obtained by the Auditor is enough for verification of Inventories.

(ii) When the auditor uses more Professional Judgement, the Degree of Inherent risk is lower. *(2 Marks each, November, 2008)*

Answer

(i) False: SA-580, "Written Representations", deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance. This SA further states that although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

(ii) True: Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. The auditor uses his professional judgment to assess inherent risk by evaluating different factor relating to the organization. On this basis he tries to ensure lower level of inherent risk.

Question 18

What points in relevance to AAS-3 should be kept in view while preparing an Audit Programme? *(6 Marks, November, 2008)*

Answer

This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

Question 19

State with reasons (in short) whether the following statements are True or False:

(i) When inherent and control risks are low, an auditor can accept a lower detection risk.

(ii) Audit procedure and Audit technique are not one and same thing.

(2 Marks each, May, 2008)

Answer

(i) False: SA-320 on "Materiality in Planning and Performing an Audit" states that the auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. After the auditor assesses the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high. The auditor reduces detection risk by performing substantive procedures - the more extensive the procedures performed, the lower the detection risk.

(ii) True: The two terms, procedure and technique are often used interchangeably. In fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling audit work and the technique stands for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence.

Question 20

Mention, any four, areas where surprise check can significantly improve the effectiveness of an audit. *(4 Marks, May, 2008)*

Answer

Areas where Surprise Check can significantly improve the Effectiveness of an Audit: Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are:

(i) Verification of cash and investments.

(ii) Inventory.

(iii) Internal control and internal checks.

(iv) Books of prime entries and statutory registers.

Question 21

Write short notes on Contents of Audit Note-book. *(5 Marks, May, 2008)*

Answer

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.

Question 22

State with reasons (in short) whether the following statement is True or False:

"There is a direct relationship between detection risk and combined level of inherent and control risk". (2 Marks, November, 2007)

Answer

False: As the auditor assesses the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high. The auditor reduces detection risk by performing substantive procedures - the more extensive the procedures performed, the lower the detection risk (SA-320 on Materiality in Planning and Performing an Audit).

Question 23

Comment on the following situations/statements:

(a) Auditor of AAS Ltd. was unable to confirm the existence and valuation of imported goods lying with the transporter and accepted a certificate from the management without obtaining other audit evidence. (8 Marks, November, 2007)

(b) M/s Health Zone, a partnership firm, running a nursing home have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year. (6 Marks, November, 2007)

Answer

(a) Accepting Written Representations without obtaining other Audit Evidence: As per SA 580 on "Written Representations" in the course of audit, an auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. In such a situation he may rely on the submission by the management but he should seek corroborative audit evidence from sources inside or outside the entity and evaluate the representation made by management.

Management representation is not a substitute for other audit evidence. The auditor should seek and apply normal audit procedure. Mere possession of a certificate does not absolve the auditor from his liability. He should not seek or accept certificates when subject matter is such that it is capable of verification from internal and/or external evidences.

In the instant case, the inventory of imported material lying with the transporter can be easily verified with purchase order, invoice, bill of entry, custom document, payment of F.C. etc.

Therefore the auditor in this instant case has not used available evidences. He should not have rested with the certificate obtained from the management and could have evaluated other evidences. He may be held liable for negligence and professional misjudgment.

(b) Ownership and Custody of Working Papers: As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion, can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Working papers are the important records of the auditor. They serve as evidence of the auditor's exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Health Zone can't insist upon the auditor to handover the working papers of the previous year.

Question 24

Explain "Precautions to be taken in applying test check technique". (6 Marks, November, 2007)

Answer

The following precautions may be taken in applying test check techniques:

(i) The transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of the same kind.

(ii) Systems and procedures for entering into and processing a transaction right from the beginning to the end should be studied in a sequential order. It involves questions of authorisations, documentation and recording and evidencing the same.

(iii) The whole of the system of internal control in the areas of accounts and finance should be studied and evaluated for its efficiency, soundness and capability for producing reliable accounting and financial data. This can be done by studying the controls and internal checks, evaluating their general soundness in the context of the business of the concern and testing their actual operation. If, and only if, the auditor is satisfied about soundness of the controls and their operation in actuality, can he decide to have test checks. For testing the operation of the control system, he should select a few transactions and check them in depth by the application of procedural tests.

(iv) A properly thought-out test check plan should be prepared and the objective of each check should be clearly understood by the auditing staff. For example, each voucher may be checked by the test check method for a number of objectives - one may be to ensure that the cash payments are properly authorised and acknowledged, others may be to see whether the amount actually payable has in fact been paid and whether the payment has been debited to the proper account. If there is a mix-up in the objectives or the objective is to test a number of variables in one test scheme, the result may not be helpful. Hence it requires a clear definition of the audit objective related to the particular test check plan.

(v) The transactions falling under each test-check plan should be selected in a manner so that bias cannot enter in the selection. For the purpose, selection should be made by reference to the random number tables.

(vi) Identification of the areas where test check may not be done. For example, if there are only 20 overseas sales in the year, it would be preferable to have them all thoroughly checked.

(vii) The number of transactions to be selected for each test-check plan should be predetermined. This can be done by deciding upon the degree of reliance that should be placed on the test-check result and the confidence that can be placed - the result to be obtained should be veering round the degree of reliance set up. Once the degree of reliance and the confidence level required in the audit for expression of the opinion have been decided, the number to be tested out of the given population can be easily known by reference to the statistical tables.

(viii) Errors that may be found may be material or immaterial in the context of the particular audit. Since errors of immaterial nature are not likely to distort the overall truth and fairness of the accounts, it is necessary to decide upon the criteria to judge what constitutes a material error. Further investigation of immaterial error may be avoided and only the material errors may be properly and thoroughly investigated.

Question 25

Write short notes on "Quality control for audit work at firm level". (5 Marks, November, 2007)

Answer

Quality control for audit work at firm level: SA 220 on Quality Control for an Audit of Financial Statements deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. Quality control systems, policies and procedures are the responsibility of the audit firm. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence. The requirements are:-

(i) **Leadership Responsibilities for Quality on Audits:** The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

(ii) **Relevant Ethical Requirements:** Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement.

(iii) **Acceptance and Continuance of Client Relationships and Audit Engagements:** The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

(iv) **Assignment of Engagement Teams:** The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement in accordance with professional standards and regulatory and legal requirements and enable an auditor's report that is appropriate in the circumstances to be issued.

(v) **Engagement Performance:** The engagement partner shall take responsibility for the direction, supervision and performance of the audit engagement. He shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures and shall take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall determine that an engagement quality control reviewer has been appointed. Further, if differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

(vi) **Monitoring**: The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

Question 26

State with reasons (in short) whether the following statements are True or False:

(a) Components of Audit Risk does not includes sampling risk.

(b) Test checks refers to the out of routine checks that are carried out in the normal course of audit. *(2 Marks each, May, 2007)*

Answer

(a) True: As per SA 200 "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; and risks of material misstatement at the assertion level consist of two components viz. inherent risk and control risk.

(b) False: Test checks refers to an audit procedure wherein only a part is checked to form an opinion instead of checking all the transactions.

Question 27

Explain "Relationship between materiality and audit risk". *(5 Marks, May, 2007)*

Answer

Relationship between materiality and audit risk: SA 320 on 'Materiality in Planning and Performing an Audit' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

Question 28

Explain in brief, the utility of Working Paper to an auditor. *(3 Marks, May, 2007)*

Answer

Utility of Working Paper: Audit working papers are very useful to the auditor in the following way:

(i) It provides guidance to the audit staff with regard to manner of checking the schedules.

(ii) The auditor is able to fix responsibility on the staff members who signs each schedule.

(iii) It acts as an 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.

Question 29

Write short notes on the following:

(a) Management Representations. *(5 Marks, May, 2007, 2 Marks, November, 2005)*

(b) Supervision of Audit work. *(5 Marks, May, 2007)*

Answer

(a) Management Representations: SA 580 "Written Representations" deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example, intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.

(b) **Supervision of Audit work:** SA 220 "Quality Control for an Audit of Financial Statements" requires that the auditor implement quality control procedures at the engagement level that provide the auditor with reasonable assurance. The engagement partner shall take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements. The supervision includes matters such as:

(i) Tracking the progress of the audit engagement.

(ii) Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the audit engagement.

(iii) Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.

(iv) Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

Question 30

Write short notes on "Audit Programme". *(4 Marks, November, 2006)*

Answer

Audit Programme: An audit programme is a detailed plan of applying the audit procedure in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. It is framed keeping in view the nature, size and composition of the business, dependability of the internal control and the given scope of work. Audit programme provides sufficient details to serve as a set of instructions to the audit team and also helps to control the proper execution of the work. On the basis of experience while carrying out the audit work, the programme may be altered to take care of situations which were left out originally, but found relevant for the particular audit situation. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, that may be dropped. There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. For the purpose of framing an audit programme the following points should be kept in view:

(i) Audit objective

(ii) Audit procedure to be applied

(iii) Extent of check

(iv) Timing of check

(v) Allocation of work amongst the team members

(vi) Special instructions based on past experience of the auditee.

Question 31

State briefly Audit Procedures and Audit Techniques. *(8 Marks, May, 2006)*

Answer

Audit Procedures: Selection of the appropriate audit procedure is again a matter of experience and judgment. For example, the normal procedure for verification of cash balance is counting but this is not practicable in respect of the cash-in-transit. The auditor has to think in advance about the possibilities of departure from the normal procedure and the areas likely to be affected thereby. The procedure should provide for such situations in the programme. Knowledge about accounting may be conveniently used in assembling the procedures in the most rational and natural manner.

According to SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit.

Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of classes of transactions, account balances or disclosures.

Audit techniques on the other hand refers to collection and accumulation of audit evidence. Some of the techniques commonly adopted by the auditors are the following:

(i) Posting checking

(ii) Casting checking

(iii) Physical examination and count

(iv) Confirmation

(v) Inquiry

(vi) Year-end scrutiny

(vii) Re-computation

(viii) Tracing in subsequent period

(ix) Bank Reconciliation

The two terms, procedure and techniques, are often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence.

Question 32

Briefly explain Control Risk. *(2 Marks, November, 2005)*

Answer

Control Risk: SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", defines the Control Risk as under:

"Control Risk" is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist.

Question 33

An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations. *(12 Marks, November, 2005)*

Answer

Receipt of Donations

(i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

(ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.

(iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

(iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.

(vi) **Foreign Contributions**, if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of donations to different NGOs

(i) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.

(ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.

(iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(iv) **Direct Confirmation Procedure**: Send confirmation letters to entities to whom donations have been paid.

(v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

Question 34

Write short notes on "Permanent Audit File". *(4 Marks, November, 2005)*

Answer

Permanent Audit File: In the case of recurring audits, some working paper files may be classified as permanent audit files. Normally, auditor may consider classifying such papers as permanent which are required in case of recurring audit assignments. This file contains paper of continuing importance to succeeding audits. A permanent audit file normally includes:

(i) Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.

(ii) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.

(iii) A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.

(iv) Copies of audited financial statements for previous years.

(v) Analysis of significant ratios and trends.

(vi) Copies of management letters issued by the auditor, if any.

(vii) Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.

(viii) Notes regarding significant accounting policies.

(ix) Significant audit observations of earlier years.

Question 35

Medical Council of India organised a three-day International Conference of Doctors in Delhi. You are asked to audit the accounts of the conference. Draft the audit programme for audit of receipt of participation fees from delegates to the conference. Mention any six points, peculiar to the situation, which you will like to include in your audit programme. (6 Marks, May, 2005)

Answer

Audit of Receipts of Participation Fees

The organization of three-day International Conference of Doctors in Delhi by Medical Council of India is a one-time event. Normally, in view of mega-size of the event, a special cell is made in the organization to handle the entire event. Since few people would be handling the event, the internal controls may not be that strong and, thus, more emphasis is required to be given on substantive procedure. Audit of receipt of participation fees should be under the following areas:

(I) Internal Control System

(i) Examine the organization structure of special cell created for the International Conference, if any, and division of responsibilities amongst persons and control/custody over receipt books.

(ii) Verify the internal control system for restricting the participation of unregistered delegates.

(II) Rate of Participation Fees

(i) Verify with reference to resolution passed by the Organizing Committee/Medical Council of India.

(ii) Also verify the rate from the literature/registration form circulated for promotion of conference.

(III) Receipts of Participation Fees

(i) Verify counter foil of the receipts issued for individual registration.

(ii) Ensure that receipts are issued for all the registration received in cash.

(iii) Trace the receipts in Bank Statement or Cash Book – as the case may be.

(iv) Verify Bank Reconciliation Statement and list out dishonoured cheques.

(v) Verify subsequent recovery in respect of dishonoured cheques.

(IV) Overall Checking

(i) Verify the total receipts of participation fees shown in the financial statements with reference to total number of receipts issued to participants.

(ii) Cross check the total number of delegates with reference to the following:

(a) Kits distributed to participants.

(b) Bill of caterer for providing meals during conference.

(c) Capacity of the Hall.

(d) Participation Certificate if any issued.

(V) Foreign Delegates: In case of foreign delegates – if registration fees are higher – ensure that they are registered at higher fees.

(VI) Special Issues

(i) Take out list of absentees and in case of nil absentees, probe the issue further.

(ii) If certain participants are exempted from payment of fees – obtain the list along with proper authorization in this regard.

Question 36

(a) Explain with reference to the relevant Auditing and Assurance Standard:

Inherent Risk (5 Marks, May, 2005)

(b) State the matters to be considered for acquiring knowledge of the business of the client by the auditor. (6 Marks, May, 2005)

Answer

(a) Inherent Risk: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

As per **SA 330 "The Auditor's Responses to Assessed Risks**", while designing the further audit procedures to be performed, the auditor shall consider the reasons for the assessment given to the risk of material misstatement at the assertion level for the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk) and obtain more persuasive audit evidence the higher the auditor's assessment of risk.

As per **SA 315 "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment"**, for this purpose, the auditor shall:

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.

(b) Obtaining Knowledge of the business: The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

As per SA 315 "**Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment**", the auditor shall obtain an understanding of the following:

(i) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework

(ii) The nature of the entity, including:

(1) its operations;

(2) its ownership and governance structures;

(3) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(4) the way that the entity is structured and how it is financed;

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(iii) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(iv) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(v) The measurement and review of the entity's financial performance.

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

Question 37

Write a short note on "Surprise Check". *(4 Marks, May, 2005)*

Answer

Surprise Check: Surprise checks are a part of normal audit procedures. An element of surprise can significantly improve the audit effectiveness. Wherever practical, an element of surprise should be incorporated in the audit procedures.

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client's office for audit and selection of areas of audit.

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client's staff. It helps in determining whether errors or frauds exist and if they exist, brings the matter promptly to the management's attention, so that corrective action can be taken at the earliest. Surprise checks are very effective in verification of cash and investments, test checking of inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

Question 38

In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of AAS 20. *(8 Marks, May, 2004)*

Answer

This Question is redundant in view of the latest Engagement and Quality Control Standards came into force.

Question 39

Write a short note on "Audit Risk". *(4 Marks, May, 2004)*

Answer

Audit Risk: An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheet items. Audit risk is a function of the risks of material misstatement and detection risk.

As per **SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"**, the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements. The nature of each of these types of risk and their interrelationship is discussed below:

(i) **Inherent risk:** It is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

(ii) Control Risk: It is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements.

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

(iii) Detection Risk: It is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.

The 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 on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

4

Internal Control

Question 1

State with reason (in short) whether the following statement is correct or incorrect:

"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. (2 Marks, November, 2013)

Answer

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.

Question 2

Explain inherent limitations of internal control systems. *(8 Marks, November, 2013)*

Or

What are the inherent limitations of Internal control? *(7 Marks, November, 2007)*

Answer

Inherent Limitations of Internal Control Systems: 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.

Question 3

Write short notes on the following:

(a) Use of flow charts in evaluation of internal control. (4 Marks, November, 2013)

(b) Internal Control Questionnaire. (4 Marks, May, 2013)

(c) Letter of Weakness. (4 Marks, May, 2013, 5 Marks, June, 2009)

Answer

(a) 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.

(b) Internal Control Questionnaire: This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

(c) Letter of Weakness

(i) The auditor does compliance procedure to ascertain that the internal control system exist in the entity, it works effectively; it work continuously in the entity during review period.

(ii) When he comes across any weakness in the control points, he issues letter of weakness.

(iii) Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism. It also suggests measures by which the weakness in the system be corrected and the control system be made better protected.

(iv) Lapses in operation of internal control too are reported in the communication of weakness.

(v) The communication of weakness is reporting to management of such weakness in design and operation of internal control as have come to notice of auditor during his auditing and it should not be taken to be a review and comment on adequacy of the control mechanism for management purpose.

Question 4

Comment "Internal check is part of internal control system". (2 Marks, May, 2013)

Answer

Internal Check is part of Internal Control System: Internal check has been defined as "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". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned.

Question 5

To prepare an audit plan in CIS environment an auditor should gather information. Mention any four such important information which he has to collect. (4 Marks, May, 2013)

Answer

Information to be gathered to prepare an Audit Plan in CIS Environment: The auditor should gather information about the CIS environment that is relevant to the audit plan, including information as to:

(i) How the CIS function is organized and the extent of concentration or distribution of computer processing throughout the entity.

(ii) The computer hardware and software used by the entity.

(iii) Each significant application processed by the computer, the nature of the processing (e.g. batch, on-line), and data retention policies.

(iv) Planned implementation of new applications or revisions to existing applications.

(v) When considering his overall plan the auditor should consider matters, such as:

(a) Determining the degree of reliance, if any, he expects to be able to place on the CIS controls in his overall evaluation of internal control.

(b) Planning how, where and when the CIS function will be reviewed including scheduling the works of CIS experts, as applicable.

(c) Planning auditing procedures using computer-assisted audit techniques.

Question 6

Write short notes on the following:

(a) Inherent risk.

(b) Cut-off arrangements. *(4 Marks, November, 2012)*

Answer

(a) Inherent risk (risk that material errors will occur): The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. It is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

(b) Cut-off arrangements*:* 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 inventory are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and inventory. 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 of 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 inventory into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking for perfect and correct presentation in the financial statements.

Question 7

What are the general considerations in framing a system of internal check? (8 Marks, May, 2012)

Or

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

(8 Marks, May, 2006)

Answer

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

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

(ii) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.

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

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

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

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

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

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

Question 8

Explain the objectives of internal audit. *(8 Marks, November, 2011)*

Answer

Objectives of Internal Audit: Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's risk management and internal control system. Now it is statutory requirement as per the provisions of section 138 of the Companies Act, 2013.

The objective of internal audit can be stated as follows:

(i) To verify the accuracy and authenticity of the financial accounting and statistical records presented by the management.

(ii) To ascertain that the standard accounting practices, as have been decided to be followed by the organisation, are being adhered to.

(iii) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.

(iv) To confirm that liabilities have been incurred only for the legitimate activities of the organisation.

(v) To analyse and improve the system of internal check in particular to see (1) that it is working ; (2) that it is sound ; and (3) that it is economical.

(vi) To facilitate the prevention and detection of frauds.

(vii) To examine the protection afforded to assets and the uses to which they are put.

(viii) To make special investigations for management.

(ix) To provide a channel whereby new ideas can be brought to the attention of management.

(x) To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

Question 9

What are CAATS? Why are CAAT required in computerized information system (CIS) environment? *(8 Marks, November, 2011)*

Answer

Computer Aided Audit Techniques (CAATs): The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. Computer

Aided Audit Techniques (CAATs) are such techniques applied through the computer which are used in the verifying the data being processed by it.

System characteristics resulting from the Computerised Information System (CIS) Environment that demand the use of Computer Aided Audit Techniques (CAAT) are:

(i) **Absence of input documents**: Data may be entered directly into the computer systems without supporting documents. In on-line transaction systems, written evidence of individual data entry authorization, e.g., credit limit approval may not be available.

(ii) **Lack of visible transaction trail**: Certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In CIS environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.

(iii) **Lack of visible output:** In a manual system, it is normally possible to examine visually the results of processing. In CIS environment, the results of processing may not be printed or only a summary data may be printed. Thus, lack of visible output may result in the need to access data retained on machine readable files.

(iv) **Ease of Access to data and computer programmes**: Data and computer programmes may be altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and allocation of, data and programmes by persons inside or outside the entity.

(v) **Audit effectiveness:** The effectiveness and efficiency of auditing procedures will be improved through the use of CAAT in obtaining and evaluating audit evidence, for example –

  (1) Some transactions may be tested more effectively for a similar level of cost by using the computer.

  (2) In applying analytical review procedures, transactions or balance details of unusual items may be reviewed and reports got printed more efficiently by using the computer.

(vi) **Savings in time:** The auditor can save time by reviewing the CIS controls using CAAT than through other audit procedures.

(vii) **Effective test checking and examination in depth**: CAAT permits effective examination in depth of selected transactions since the auditor constructs the lost audit trail.

Question 10

Write short notes on Internal control in small business. *(4 Marks, May, 2011)*

Answer

Internal control in small business: The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both small and large entities. However, many controls which would be relevant to large entities are not practical in the small business e.g. in small business accounting work may be performed by only a few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severally limited.

Inadequate segregation of duties may, in some cases, be offset by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in the business transactions. In circumstances where segregation of duties is limited or evidence of supervisory controls is lacking, the evidence necessary to support the auditors' opinion on the financial information may have to be obtained largely through the performance of substantive procedure.

Question 11

(a) Explain briefly the technique of "Internal Control Questionnaire" to facilitate the accumulation of information necessary for proper evaluation of internal control.

(4 Marks, November, 2010)

(b) State clearly the circumstances where "Auditing through the computer" approach must be used. *(6 Marks, November, 2010)*

Answer

(a) Internal Control Questionnaire: Internal control questionnaire is a comprehensive series of questions concerning internal control. It is the most widely used form for collecting information about the existence, operation and efficiency of internal control in the organisation.

In the questionnaire, questions are generally so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies *or* apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail.

(b) 'Auditing through the computer approach': The auditor can use the computer to test:

(a) The logic and controls existing within the system.

(b) 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.

Following are several circumstances where auditing through the computer approach must be used:

(i) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.

(ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.

(iii) The logic of the system is complex and there are large portions that facilitate use of the system for efficient processing.

(iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

Question 12

'Doing the audit in EDP environment is simpler since Trial Balance always tallies. 'Analyse the statement critically. (5 Marks, May, 2010)

Answer

Audit in EDP environment: Though it is true that in EDP environment the trial balance always tallies, the same can not imply that the job of an auditor becomes simpler. There can still be some accounting errors like omission of certain entries, compensating errors, duplication of entries, errors of commission in the form of wrong head of accounts etc. Possibility of "Window Dressing" and/or "Creation of Secret Reserves" can be possible in EDP environment also in spite of tallied trial balance. At present, due to complex business environment the importance of trial balance cannot be judged only upto the arithmetical accuracy but the nature of transactions recorded and its classification in the books should be focused.

The emergence of new forms of financial instruments like options and futures, derivatives, off balance sheet financing etc have given rise to further complexities in recording and disclosure of transactions. In an audit, besides the tallying of a trial balance, there are other issue also like estimation of provision for depreciation, estimation of tax liability, valuation of inventories, obtaining audit evidence, ensuring compliance with various laws, regulations and standards, verification of existence and valuation of assets and liabilities, reporting requirement as per statute etc. which still requires judgement to be exercised by the auditor.

The EDP processing and recording has its own complexities and requires lot of controls, safeguards and application which requires specialised knowledge and skill for proper implementation.

Responsibility of expressing an audit opinion and objectives of an audit are not changed in the audit in EDP environment. Compliance with various laws and standards are still to be verified, ensured and reported.

Therefore, it can be said that simply because of EDP environment and tallying of the trial balance, the audit can't be said to have become simpler.

Question 13

Discuss Internal Controls in a CIS Environment. *(5 Marks, May, 2010)*

Answer

Internal controls in CIS Environment: The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programmes. Such manual and computer controls affect the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls: The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. These controls may include:

(1) Organisation and management controls are designed to establish an organizational framework over CIS activities, including:

   (i) Policies and procedures relating to control functions.

   (ii) Appropriate segregation of incompatible functions.

(2) Application systems development and maintenance controls are designed to establish control over:

   (i) Testing, conversion, implementation and documentation of new or revised systems.

   (ii) Changes to application systems.

   (iii) Access to systems documentation

   (iv) Acquisition of application systems from third parties.

(3) Computer operation controls are designed to control the operation of the systems and to provide reasonable assurance that:

   (i) The systems are used for authorised purposes only.

   (ii) Access to computer operations is restricted to authorised personnel.

   (iii) Only authorised programs are used.

   (iv) Processing errors are detected and corrected.

(4) Systems software controls include:

   (i) Authorisation, approval, testing, implementation and documentation of new systems software and systems software modifications.

   (ii) Restriction of access to systems software and documentation to authorised personnel.

(5) Data entry and program controls are designed to provide reasonable assurance that:

(i) An authorisation structure is established over transactions being entered into the system.

(ii) Access to data and programs is restricted to authorised personnel.

(iii) Offsite back-up of data and computer programmes.

(iv) Recovery procedures for use in the event of theft, loss or international or accidental destruction.

(v) Provision for offsite processing in the event of disaster;

CIS Application Controls: The purpose of CIS application controls is to establish specific control procedures over the accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis. These include:

(1) Controls over input are designed to provide reasonable assurance that:

(i) Transactions are properly authorised before being processed by the computer.

(ii) Transactions are accurately converted into machine readable form and recorded in the computer data files.

(iii) Transactions are not lost, added, duplicated or improperly changed.

(iv) Incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.

(2) Controls over processing and computer data files are designed to provide reasonable assurance that:

(i) Transactions, including system generated transactions, are properly processed by the computer.

(ii) Transactions are not lost, added, duplicated or improperly changed.

(iii) Processing errors are identified and corrected on a timely basis.

(3) Controls over output are designed to provide reasonable assurance that:

(i) Results of processing are accurate.

(ii) Access to output is restricted to authorised personnel.

(iii) Output is provided to appropriate authorised personnel on a timely basis.

Question 14

State with reasons (in short) whether the following statement is True or False:

The overall objective of audit changes in Computer Information System (CIS) environment.

(2 Marks, November, 2009)

Answer

False: Overall objective of audit does not change in Computer Information System (CIS) environment. But the use of computer changes the processing and storage, retrieval and communication of financial information.

Question 15

State with reason (in short) whether the following statement is correct or incorrect:

"Auditing 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". (2 Marks, June, 2009)

Answer

False: Auditing in depth does not mean cent percent or near cent percent vouching. It is checking selected transactions from beginning to end to understand and vet the system within which the transaction passes through.

Question 16

Mention any six points to be considered for good internal control for collection of tuition fees from students of college. (6 Marks, June, 2009)

Answer

Internal control points for collection of tuition fees:

(i) There must be a clear cut tuition fee structure approved by the college council.

(ii) The challan or paying in slip should contain necessary fields for identifying the roll number of the student, class, and period for which fees is paid etc. The slips should have such number of counterfoils to cross check the remittance.

(iii) The paying in slip when filled by the students should be checked for its correctness as to applicable amount etc. by one clerk and the amount should be entered in a scroll. He must initial the slip which authorises the cashier to accept the fees as per slip.

(iv) The cashier scroll and the authorising officer/s scroll should be checked by an officer daily.

(v) All remittance should be banked each day. No amount should be allowed to be spared for meeting any type of expense.

(vi) Alternatively, the fees may be directly remitted into bank and banker's daily remittance slip should be scrutinised by college officers.

(vii) Arrears list should be periodically prepared from the students rolls. Any concession, remission of tuition fees should have approval of competent authority.

(viii) Delayed remittance should carry fines or compensating charges for delay.

(ix) When students are readmitted after removal for non-payment of fees, the admission should carry the permission of competent authority.

Question 17

State with reasons (in short) whether the following statement is True or False:

"The environment in which internal control operates has no relationship with the effectiveness of the Specific control procedure". (2 Marks, November, 2008)

Answer

False: The environment in which internal control operates has an impact on the effectiveness of the specific control procedure. For example, strong control environment in association with effective internal audit system strengthen the internal control system.

Question 18

As an Auditor how would you react to the following situation/comment?

A company has ₹ 60 lakh of paid up Capital and ₹ 3 crore of average Annual Turnover of past three years preceding the Financial year under Audit. The company does not have any Internal Audit system because the Management does not think it necessary.

(6 Marks, November, 2008)

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(a) every listed company;

(b) every unlisted public company having-

   (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

   (ii) turnover of two hundred crore rupees or more during the preceding financial year; or

   (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

   (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

   (i) turnover of two hundred crore rupees or more during the preceding financial year; or

   (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Thus, any of the condition is required to be satisfied for the applicability of the provision. The internal auditor to be appointed shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company.

In the instant case, the company is having paid up capital less than ₹ 50 crore and turnover less than ₹ 200 hundred crore. Further, maximum outstanding loan or borrowing from public financial institution has not been given. Therefore assuming that outstanding loans or borrowings from banks or public financial institutions are also not exceeding ₹ 100 crore during the previous financial year. Therefore, any of the condition in respect of paid up capital, turnover or outstanding loans is not satisfied. So the company is not liable for internal audit as per section 138 of the Companies Act, 2013.

Question 19

In a CIS environment, what are the different Design and Procedural aspects, which are different from those found in Manual systems? (4 Marks, November, 2008)

Answer

These different design and procedural aspects of systems include:

(i) **Consistency of performance:** CIS system performed functions are more reliable provided that all transactions types and conditions that could occur are anticipated and incorporated into the system.

(ii) **Programme control procedures:** These procedures can be designed to provide controls with limited visibility.

(iii) **Single transaction update of multiple or data base computer file:** A single input into the accounting system may automatically update all records associated with the transaction.

(iv) **Systems generated transactions:** Certain transactions may be initiated by the CIS system itself without the need for an input document. E.g., Interest may be calculated and changed automatically to customer's account balances.

(v) **Vulnerability of data and programme storage media:** Large volume of data may be stored on portable or fixed storage media, such as magnetic disks and tapes.

Question 20

How would you assess the reliability of Internal control system in computerized information system? (6 Marks, May, 2008)

Answer

Reliability of Internal Control System in CIS: For evaluating the reliability of internal control system in CIS, the auditor would consider the followings:-

(i) That authorised, correct and complete data is made available for processing.

(ii) That it provides for timely detection and corrections of errors.

(iii) That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.

(iv) That it ensures the accuracy and completeness of output.

(v) That it provides security to application softwares & data files against fraud etc.

(vi) That it prevents unauthorised amendments to programs.

Question 21

Why are computer assisted audit techniques (CAAT) needed in a Computer Information Systems (CIS) environment and how it helps the auditor in obtaining and evaluating audit evidences? (6 Marks, November, 2007)

Answer

Computer Assisted audit techniques (CAAT) may be required in a CIS environment in the following circumstances:

- The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
- The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
- The lack of visible output may necessitate access to data retained on files readable only by the computer.

The effectiveness and efficiency of auditing procedures may be improved through the use of computer-assisted audit techniques in obtaining and evaluating audit evidence, for example:

(i) Some transactions may be tested more effectively for a similar level of cost by using the computer to examine all or a greater number of transactions than would otherwise be selected.

(ii) In applying analytical review procedures, transactions or balance details may be reviewed and reports printed of unusual items more efficiently by using the computer than by manual methods.

Question 22

Write short notes on "Examination in depth". (5 Marks, November, 2007)

Answer

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.

Question 23

Explain "Relationship between Statutory Auditor and internal Auditor". (5 Marks, May, 2007)

Answer

Relationship between Statutory Auditor and Internal Auditor: The function of an internal auditor being an integral part of the system of internal control. It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor.

Though the roles and primary objectives of internal and statutory audit differs, some of their means of achieving their respective objectives are similar. Thus, much of the work of the internal auditor may be useful to the statutory auditor in determining the nature, timing and extent of his audit procedures. Depending upon such evaluation, the statutory auditor may be able to adopt less extensive procedures.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he may accept the checking/evaluation carried out by the internal auditor in the area of internal control, verification of assets and liabilities etc.

It must however be mentioned that the area of co-operation between the statutory and internal auditor is limited by the fact that both owe their allegiance to separate authorities, the shareholders in the case of statutory auditor and the management in the case of internal auditor.

Question 24

Distinguish between Internal Control Questionnaire and Internal Control Evaluation.

(5 Marks, May, 2007)

Answer

Internal Control Questionnaire (ICQ) and Internal Control Evaluation (ICE): The internal control questionnaires show the area where weakness occur or likely to occur. They do not give any idea of the importance of those weaknesses. The Internal Control Evaluation brings to light importance of those weakness disclosed by ICQ.

Main points of distinctions are:

(i) ICQ incorporates a large number of detailed questions but does not attempt to distinguish their relation in materiality. ICE isolates the main control objectives within the area of review.

(ii) Weaknesses are highlighted by answer “Yes” on ICE compared with ‘No’ on ICQ.

(iii) Answer ‘no’ in ICQ indicates a weakness real or potential, but its significance is not revealed. Whereas ICE requires audit personnel to state whether, an apparent weakness may prove to be material in relation to the accounts as a whole.

(iv) The ‘Control Checklist’ in ICE is more than a summary of key control factors, and is no substitute for ICQ.

Question 25

State the circumstances where the auditing through the computer must be used.

(5 Marks, May, 2007)

Answer

Auditing Through the Computer: There are several circumstances where auditing through the Computer must be used:

(i) The application system processes large volumes of input and produces large volumes of output that makes extensive direct examination of the validity of input and output difficult.

(ii) Significant parts of the internal control system are embodied in the computer system.

(iii) The logic of the system is complex and there are portions that facilitate use of the system or efficient processing.

(iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

Question 26

As an Auditor, comment on the following situation/statement:

JKT 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 Marks, November, 2006)*

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(a) every listed company;

(b) every unlisted public company having-

  (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

  (ii) turnover of two hundred crore rupees or more during the preceding financial year; or

  (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

  (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

  (i) turnover of two hundred crore rupees or more during the preceding financial year; or

  (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Thus, any of the condition is required to be satisfied for the applicability of the provision. The internal auditor to be appointed shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company.

In the instant case, JKT Ltd. is having paid up capital less than ₹ 50 crore and turnover less than ₹ 200 hundred crore. Further, maximum outstanding loan or borrowing from public financial institution has not been given. Therefore assuming that outstanding loans or borrowings from banks or public financial institutions are also not exceeding ₹ 100 crore during the previous financial year. Therefore, any of the condition in respect of paid up capital, turnover or outstanding loans is not satisfied. So the company is not liable for internal audit as per section 138 of the Companies Act, 2013.

Question 27

What do you understand by Internal checks? *(6 Marks, November, 2006)*

Answer:

Internal Check: It means checks on day to day transaction which operate continuously as part of the routine system whereby the work of one person is proved independently or is complimentary to the work of another. The object of internal check is mainly prevention or early detection of fraud or error-intentional or unintentional. By employing a good system, the chances of occurrence of errors or fraud or their remaining undetected are greatly reduced. Internal check is a part of the overall internal control system and operates as a built-in-devices as far as the staff organisation and job allocation aspects of the control system are concerned. The system in accounting implies organization of system of bookkeeping and arrangement of staff in such a manner that no one person can completely carry through a transaction and record every aspect thereof.

Therefore it is increasingly being recognised that for an audit to be effective, especially when the size of a concern is large, the existence of a system of internal check is essential. The auditor can rely on sound system of internal check and on that consideration, reduce the extent of detailed checking to be carried out by him. Scope of audit can be reduced by both the time and cost factors.

Question 28

Why are Computer Aided Audit Techniques (CAAT) required in EDP audit? What are the advantages of CAATs? *(10 Marks, May, 2006)*

Answer:

Computer Aided Audit Techniques (CAATs): The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. CAATs are such techniques applied through the computer which are used in the verifying the data being processed by it. System characteristics resulting from the nature of EDP processing that demand the use of Computer Aided Audit Techniques (CAAT) are:

(i) **Absence of input documents:** Data may be entered directly into the computer systems without supporting documents. In on-line transaction systems, written evidence of individual data entry authorization, e.g., credit limit approval may not be available.

(ii) **Lack of visible transaction trail:** Certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In an EDP environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.

(iii) **Lack of visible output:** In a manual system, it is normally possible to examine visually the results of processing. In EDP systems, the results of processing may not be printed or only a summary data may be printed. Thus, the lack of visible output may result in the need to access data retained on machine readable files.

(iv) **Ease of Access to data and computer programmes:** Data and computer programmes may be altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and allocation of, data and programmes by persons inside or outside the entity.

Advantages of CAAT

(i) **Audit effectiveness:** The effectiveness and efficiency of auditing procedures will be improved through the use of CAAT in obtaining and evaluating audit evidence, for example –

  (a) Some transactions may be tested more effectively for a similar level of cost by using the computer.

  (b) In applying analytical review procedures, transactions or balance details of unusual items may be reviewed and reports got printed more efficiently by using the computer.

(ii) **Savings in time:** The auditor can save time by reviewing the EDP controls using CAAT than through other audit procedures.

(iii) **Effective test checking and examination in depth:** CAAT permits effective examination in depth of selected transactions since the auditor constructs the lost audit trail.

Question 29

Is there any change in audit approach in the audit of computerised accounts as compared to audit of manual accounts? *(8 Marks, November, 2005)*

Answer

Audit Approach in Respect of Computerised Accounts: The principal objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to ensure that the financial statements reflect a true and fair view. The scope of an audit of financial statements is determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. This would involve assessment of reliability and sufficiency of the information contained in the accounting records and other source data by study and evaluation of accounting system and internal controls in operation. The overall objective and scope of an audit does not change in an EDP environment but the use of a computer changes the processing and storage of financial information and may affect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment. The computerisation of accounts would also have an impact on the increase in fraud and errors. Unless there is well laid down control with regard to use of programme, access, processing and other operations, the auditor runs the risk of material misstatement appearing in the financial statement. Thus when auditing in an EDP environment, the auditor should have sufficient understanding of computer hardware, software and processing systems to plan the engagement and to understand how EDP affects the study and evaluation of internal control and application of auditing procedures including computer-assisted audit techniques. The auditor should also have sufficient knowledge of EDP to implement the auditing procedures, depending on the particular audit approach adopted. Again, there is lack of audit trail (in a one to one fashion) in a highly computerised environment (e.g. on-line system). In such a case, the auditor has to ensure that data fed are correctly, and reliably processed; no unauthorised data are fed; the output produced to him had not been manipulated. In such a case, the auditor has to audit through the computer.

Thus, it is clear from the above that overall objective and scope of audit does not change irrespective of fact that whether the accounting information is generated manually or through EDP.

Question 30

What do you understand by:

(i) Auditing around the computer?

(ii) Auditing through the computer? *(4 Marks each, May, 2005)*

Answer

(i) Audit around the Computer: Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into account. Rather the principle of conventional audit like examination of internal controls and substantive testing is done. The auditor views the computer as a black box, as the application system processing is not examined directly. The main advantage of auditing around the computer is its simplicity. Audit around the computer is applicable in the following situations:

(a) The system is simple and uses generalised software that is well tested and widely used.

(b) Processing mainly consists of sorting the input data and updating the master file in sequence.

(c) Audit trail is clear. Detailed reports are prepared at key processing points within the system.

(d) Control over input transactions can be maintained through normal methods, i.e. separation of duties, and management supervision.

Generalised software packages, like payroll and provident fund package, accounts receivable and payable package, etc. are available, developed by software vendors. Though the auditor may decide not to go in details of the processing aspects, if there are well tested widely used packages provided by a reputed vendor. However, he has to ensure that there are adequate controls to prevent unauthorised modifications of the package. However, it may be noted that all such generalised packages do not make the system amenable to audit. Some software packages provide generalized functions, that still must be selected and combined to achieve the required application system. In such a case, instead of simply examining the systems input and output, the auditor must check the system in depth to satisfy himself about such system. The main disadvantages of the system of auditing around the computer are:

(a) It is not beneficial for complex systems of large scale in very large multi unit, multi locational companies, having various inter unit transactions. It can be used only in case of small organisations having simple operations.

(b) It is difficult for the auditor to assess the degradation in the system in case of change in environment, and whether the system can cope with a changed environment.

(ii) Auditing through the Computer: This approach involves actual use of computer for processing the information by auditor. The circumstances, where auditing through the computer is done are as follows:

(a) The organisation has developed either in house or through a reputed vendor, a software package suitable to its requirement, because of inability of a generalized package to cater to the complex nature of transactions.

(b) The system processes very large volumes of output. This makes examination of validity of input and output difficult.

(c) The major part of the internal control system in the organisation is in the computer system itself, as the majority of the records is processed through the computer. Examples are system in bank, insurance companies, online booking in case of Railway, etc.

(d) The logic of the system is quite complex, and there is virtually no visible audit trail. The auditor has to use the computer to test the logic and controls existing within the system.

The auditor has to use the computer system itself for verification, for which he has to be sufficiently computer literate, and should have adequate technical knowledge and expertise. The auditor can through the computer, increase his performance, and can rely on the data processing by carrying out the required tests and applying his skill.

Question 31

Write a short note on "Independence of Internal Auditor". *(4 Marks, May, 2005)*

Answer

Independence of Internal Auditor: As per section 138 the internal auditor, who shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company. Further, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

So, the concept of independence is equally relevant for internal auditor also. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. As mentioned above that internal auditor may be part of the management but he evaluates the functioning of the management at different levels.

Therefore, to be efficient and effective, the internal auditor must have adequate independence. It may be noted that by its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. To ensure his independence he is made responsible directly to the Board of Directors through audit committee. Such a channel of communication provides an independent mode whereby an internal auditor can communicate and share his views on the scope of internal audit, findings, etc. If internal auditor is made subordinate to lower level, his independence will be effected which will affect his functioning and effectiveness. An outsider, like a firm of chartered accountants, if acting as internal auditor, is likely to be more independent than an employee of the organization.

Question 32

Write short notes on "Audit trail in a computerized accounting environment".

(4 Marks, November, 2004)

Answer

Audit Trail in a Computerised Accounting Environment: An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. The work of an auditor would be hardly affected if ªAudit Trailº is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail. The particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

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

In such a system

(i) The output itself is as complete and as detailed as in any manual system.

(ii) The trail, from beginning to end, is complete, so that all documents may be identified by located for purposes of vouching, totalling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction. In case audit trail is missing, the auditor employs Computer Assisted Techniques (CAATs) to ensure the validity of accounting data.

Question 33

What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool. *(8 Marks, May, 2004)*

Answer

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.

Question 34

Explain the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at Service Bureau? (10 Marks, May, 2004)

Answer

Requirements of Internal Control System at a Service Bureau: Various requirements to establish or evaluate a system of internal control for applications processed at a service bureau are stated below:

(i) Liaison between bureau and user should be clearly defined. Senior member of the user's staff is appointed as liaison officer.

(ii) Need for a system testing including all clerical procedures at the user company.

(iii) Control over physical movement of data and in this respect whether a copy or microfilm of documents sent to the service bureau is kept.

(iv) Planning procedure so that error is identified by documents provided by the bureau. The user must ensure that prompt correction and resubmission of rejection to meet the bureau processing schedule.

(v) Establishing a system in the user company to ensure that all exceptional reports are received from bureau.

(vi) Establish clerical control to verify the accuracy of computer processing.

(vii) Normally, user has no physical control over the files, therefore, high control over the maintenance of data on master files should be established.

Question 35

"Installation of Computer Operating System have created both benefits and problems for auditors". Explain the Statement? (6 Marks, May, 2004)

Answer

Computer Operating Systems and the Auditor: The installation of computer operating system is an integral and absolutely essential part of a computer even in a standalone PC-based environment. In fact it is difficult to visualize a computer to be operational without installation of the operating system. With the advancement of technology, the operating systems are part of the server or hard disc and provide lot of options and flexibility to the user. The provision of all these built-in-features are quite beneficial to user and the auditor alike. The data stored in the system can be extracted depending upon the requirement, e.g., records relating to students can be region-wise, city-wise, examination centre-wise, etc to compare the performance. At the same time, these advanced features of operating systems have given rise to several general hazards associated with it. In these circumstances, it becomes essential to restrict the access to data by ensuring proper security system such as passwords and other access controls, etc. However, such system at time can be hacked and then the entire database is vulnerable to manipulation. Thus, from the auditor's point of view installation of operating system have created both benefits and problems. The major benefits flow from the fact of examination of execution of transactions, taking samples, etc. while problems might arise to potential manipulation of the data. It May however, be noted that benefits from the operating system for outweigh the problems associated with it.

5

Vouching

Question 1

How will you vouch and verify the following:

(a) Remuneration paid to directors. (4 Marks, November, 2013)

(b) Profit or loss arising on sale of plots held by real estate dealer.(4 Marks, November, 2013)

(c) Advertisement expenses.

(4 Marks, November, 2013, 5 Marks, May, 2008, 4 Marks, May, 2005)

(d) Purchase with invoice. (4 Marks, May, 2013)

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 as per Section 196 of the Companies Act, 2013.

(ii) Examine Articles of Association and general meeting resolution to determine the manner of payment-monthly or at a specified percentage of the net profits of the company or partly by one way and partly by the other as per the provisions of Section 197(6) of the Companies Act, 2013.

(iii) Check agreement with the director.

(iv) Verify director's attendance in the board meetings.

(v) Ensure compliance with the provisions of Sections 197, 198 and Schedule V of the Companies Act, 2013, where appropriate.

(vi) Check computation of the net profits and the commission payable to directors in terms of Schedule III to the Companies Act, 2013.

(vii) Computation of net profit under section 198 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) 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.

(c) 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.

(d) Purchase with invoice: While vouching entries for purchases with the invoices, the following points should be specially observed:

(i) that the date of invoice falls within the accounting period;

(ii) that the invoice is made out in the name of the client;

(iii) that the supplier's account has been credited with the full amount of the invoice and that the deduction in the amount of the invoice, if any, has been made on a proper basis;

(iv) that the goods purchased are those that are regularly dealt in by the concern or required for the process of manufacture carried on by it and that the price payable has been correctly arrived at;

(v) that the cost of purchases has been debited to an appropriate nominal account or accounts;

(vi) that the invoice is signed by the accountant to show that he has verified it as well as the store-keeper to indicate that the delivery of goods have been taken by him. If the invoice relates to the purchase of a technical store or a chemical, the price whereof is dependent on its quality, a copy of the report of a technical person showing that the article purchased is of the specification for which the order has been placed; and

(vii) that the manager or some other official, competent to sanction payment, has authorised its payment.

Question 2

Comment on the following:

(a) PQR Ltd. include underwriting commission and stamp duty as preliminary expenses.

(2 Marks, May, 2013)

(b) Vouching of payment of taxes. *(5 Marks, November, 2011)*

Answer

(a) Preliminary Expenses: The expenditure incidental to the creation and floating of a company includes stamp duties, registration fees, legal costs, accountant's fees, cost of printing, etc. Underwriting commission and brokerage paid for shares and debentures should not be included under the head preliminary expenses. Therefore, PQR Ltd should include stamp duty as preliminary expense but exclude underwriting commission.

(b) Vouching of Payment of Taxes:

(i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made there under.

(ii) Review adjustments, expenses disallowed, special rebates etc. with particular reference to the last available completed assessment.

(iii) Examine relevant records and documents pertaining to payment of advance tax, self assessment tax and other demands.

(iv) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.

(v) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.

(vi) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

(vii) Ensure that the requirements of AS 22 on 'Accounting for Taxes on Income' have been appropriately followed for the period under audit.

Question 3

Explain, what are the factors to be considered while "Vouching of travelling expenses"?

(8 Marks, November, 2012)

Answer

The following factors are to be considered while "Vouching of Travelling Expenses":

(i) Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.

(ii) As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

(iii) The voucher for travelling expenses should normally contain the under mentioned information:

(1) Name and designation of the person claiming the amount.

(2) Particulars of the journey.

(3) Amount of railway or air fare.

(4) Amount of boarding or lodging expenses or daily allowance alongwith the dates and times of arrival and departure from each station.

(5) Other expenses claimed.

(iv) If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source.

(v) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified.

(vi) The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.

(vii) The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.

(viii) Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

Question 4

Write short notes on the following:

(a) Audit of discounted bills receivable dishonoured.

(b) Examination in depth. *(4 Marks each, November, 2012)*

Answer

(a) Audit of Discounted Bills Receivable Dishonoured

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

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

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

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

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

(b) 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 of 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, if payment to a creditor is to be verified "in depth", it would be necessary to examine the following documents:

(i) The invoice and statement of account received from the supplier.

(ii) The entry in the stock record showing that the goods were received.

(iii) The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.

(iv) The copy of the original order and authority showing that the goods in fact were ordered by an authority which was competent to do so.

It is to be emphasized that, so far as the management is concerned, the internal control should have willing acceptance at the hands of the employees and there should exist proper mechanism for such motivation.

Question 5

How will you verify/ vouch the retirement gratuity to employees? (6 Marks, May, 2012)

Or

How will you vouch and verify Payment of Retirement Gratuity to employees.

(5 Marks, November, 2007)

Answer

Vouching / Verification of Retirement Gratuity to Employees

(i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

(ii) Verify computation of liability of gratuity on the aggregate basis.

(iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

(iv) See that the annual premium has been charged to Statement of Profit and Loss case the concern has taken a policy from LIC.

(v) Ensure that the basis of computing gratuity is valid.

(vi) Ensure that the accounting treatment is in accordance with AS 15, "Employee Benefits".

(vii) Ensure that the following disclosure requirements of Schedule III to the Companies Act, 2013 have been followed:

In respect of Statement of Profit and Loss, a Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items: (i) (a) ***Employee Benefits Expense*** [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses];
➢ **Long-term provisions:** The amounts shall be classified as: (a) ***Provision for employee benefits;*** (b) Others (specify nature)
➢ **Short-term provisions:** The amounts shall be classified as: (a) ***Provision for employee benefits;*** (b) Others (specify nature).

Question 6

List out some examples of fraud that can be done by ledger keeper in Bought ledger and sales ledger. (8 Marks, May, 2011)

Answer

Ledger Keeper & Frauds: Examples of frauds that can be done by ledger keeper in bought ledger:

(i) Crediting the account of a supplier on the basis of a fictitious invoice, showing that certain supplies have been received from the firm, whereas in fact no goods have been received or on the basis of duplicate invoice from a supplier, the original amount whereof has already been adjusted to the credit of the supplier in the Bought Ledger, and subsequently misappropriating the payment made against the credit in the supplier's accounts.

(ii) Suppressing a credit note issued by a supplier in respect of return or an allowance and misappropriating an amount equivalent thereto out of the payment made to him. For if a credit note issued by a supplier either in respect of goods returned to him or for an allowance granted by him, is not debited to his account, the balance in his account in the Bought Ledger would be larger than the amount actually due to him. The ledger-keeper thus will be able to misappropriate the excess amount standing to the supplier's credit.

(iii) Crediting an amount due to a supplier not in his account but under a fictitious name and misappropriating the amount paid against the credit balance.

Examples of frauds that can be done in sales ledger:

(i) Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(ii) Adjusting an unauthorised credit or fictitious rebate, allowance, discount, etc. in the account with a view to reduce the balance and when payment is received from the trade receivable, misappropriating an amount equivalent to the credit.

(iii) Writing off the amount receivable from a customer's bad debt account and misappropriating the amount received in payment of the debt.

Question 7

Give various factors which result in increase in Gross profit. *(8 Marks, May, 2011)*

Answer

Factors which increase the gross profit:

(i) Undervaluation of opening inventory; it may be either the effect of non-inclusion of certain items of inventories or that of valuation of the inventory at a rate lower than that warranted by the basis of valuation adopted or miscalculation of the value of one or more items of inventory. In such a case, the increase in the rate of gross profit would be preceded by a fall in the rate of gross profit in the previous year.

(ii) Overvaluation of closing inventory, either by the inclusion therein of fictitious items of inventory or over-statement of values of some of them.

(iii) Alteration of the basis of valuation of closing inventory, e.g., where the opening inventory was valued at cost or market rate whichever was lower, valuing the closing inventory at the market price which is higher than cost.

(iv) Increase in the value of some of the items included in the opening inventory above cost, on account of which the unsold inventory of these items at the close of the year is valued at cost.

(v) Under-statement of opening inventory or over-statement of closing inventory, due to adjustment of the amount of sales, when goods sold but not delivered are included in the closing inventory or when goods were delivered and taken out of inventory last year, but sales invoices is raised in the current year.

(vi) Entry of fictitious purchases to boost up the profits, if such a practice has been resorted to, it would have the effect of reducing the rate of gross profit in the ensuing year.

(vii) Inclusion in the closing inventory of goods returned awaiting despatch to supplier, the cost of which has been debited to them or goods returned by customers, the cost whereof has not been credited to parties.

(viii) Inclusion in the closing inventory of goods received for the sale on approval or on a consignment basis.

(ix) Treatment of goods sent out for sale on consignment basis as regular sales.

(x) No provision or under-provision in the expenses accounts included in the Trading Account. For example, purchase may be understated; provision for outstanding wages or carriage inward may not have been made.

(xi) Wrong allocations of expenses, *e.g.,* carriage inwards either in whole or in part may be wrongly taken to the Statement of Profit and Loss.

Question 8

Write short note on "Cut-off procedure". *(4 Marks, May, 2011, 5 Marks, November, 2007)*

Answer

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 procedure that is made for this purpose is technically known as "cut-off procedure".

It means procedure employed to ensure the separation of transaction at the end of one year from those in the commencement of the next year. Principle areas of application of cut-off procedures involve sales, purchase and inventory.

The auditor generally examines the last cut-off document at the end of each year. There after the auditor examines a sample of documents evidencing the movement of inventory into and out of stores, including documents pertaining to period shortly before and shortly after the cut off date and check whether the stocks and sales are appropriately reflected in the right accounting period.

It is the duty of the auditor to satisfy himself that:-

(i) Goods purchased for which property has passed to the client has been included in the inventory and that liability has been provided for in case of credit purchase.

(ii) Goods sold have been excluded from inventories and credit has been taken for sales**.** If the value of sales is to be received, the concerned party has been debited.

Question 9

Write short note on "Verification of credit sales". *(4 Marks, November, 2010)*

Answer

Verification of the credit sales

The credit sales should be verified by reference to copies of invoices issued to customers and, in the process, attention should be paid to the following matters:

(i) that each item of sales relates to the period of account under audit;

(ii) that the goods are those that are normally dealt in by the concern;

(iii) that the sale price has been correctly arrived at and the copy of the requisition slip issued by the Sales Department and the copy of the Despatch Note showing the date and mode of despatch of goods are attached with the invoice;

(iv) that the amount of the invoice has been adjusted in an appropriate account; and

(v) that the sale has been authorised by a responsible official and in token thereof he has initialed the invoice; also that any alteration in the invoice has been attested by the same person.

Question 10

What points shall an auditor keep in mind while auditing an account of Bought Ledger having a debit balance? *(4 Marks, November, 2010)*

Answer

Auditing an account of Bought Ledger: The structure of every account in the Bought Ledger is: opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule III to the Companies Act, 2013. The maximum account due from the directors or other officers of the company at any time during the year and debts due from companies under the same management should also be disclosed alongwith the names of companies (Part I, Schedule III to the Companies Act, 2013).

Question 11

State with reasons (in short) whether the following statements are True or False:

(i) The auditor compares entries in the books of accounts with vouchers and if two agrees, his work is done.

(ii) Confirmations received by the auditor directly from third parties are conclusive evidence in support of a transaction. *(2 Marks each, May, 2010)*

Answer

(i) False: The totalling of entries in the books with vouchers shows fairness of financial statements. But auditor has to determine reliability of annual statement of accounts alongwith the truth and fairness.

(ii) False: Confirmations received directly from the third parties by the auditor are more reliable but same cannot be treated as conclusive evidence.

Question 12

A trader is worried that inspite of substantial increase in sales compared to earlier year, there is considerable fall in Gross Profit after satisfying himself that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants to ensure that purchases have been truthfully recorded.

How will you proceed with this assignment? *(10 Marks, May, 2010)*

Answer

There are three steps involved in such an assignment.

A. Study and evaluation of internal control system

B. Vouching of purchase transactions

C. Analytical procedures

A. Study and evaluation of internal control system

This involves the following steps:

(i) **Internal check:** It should consist of the segregation of duties at the following points:

(a) **Requisitioning the goods:** Specified employees from the stores department or from the production department's store unit should prepare and approve a purchase requisition for raw materials or goods used in production. The purchase requisition is sent to the purchase department.

(b) **Ordering the goods requisitioned:** The purchase department is responsible for negotiating the best prices, fixing delivery dates with suppliers and ensuing that appropriate quality goods are obtained. It should prepare a serially numbered purchase order.

(c) **Receiving the goods ordered:** Goods ordered should be inspected and counted by the receiving department. If satisfied, it prepares serially numbered receiving report or goods received note and forwards its notification copies to the stores, purchase department and finance department.

(d) **Preparing the payment voucher:** The accounts payable department or accounts payable unit of finance department will receive the invoices and process for its payment and accounting.

(ii) **Physical controls**

(a) Physical controls over inventory include locked warehouses and store-rooms and limiting access to them to authorised personnel and

(b) Printed and pre-numbered forms should be used for purchase requisitions, purchase orders, receiving reports and vouchers.

(iii) **Authorised procedures**

(a) Re-order points should be established for various inventory items that may trigger a manual request.

(b) Authorisation procedures should be designed for all the four control points – requesting the goods, ordering the goods requisitioned, receiving the goods ordered and preparing the payment voucher.

(iv) **Internal review**

(a) It should ensure that there is adequate separation of duties and proper authorisation procedures with regard to processing and recording of purchase transactions.

(b) Paid invoices should be reviewed to ascertain the accuracy of the recording of these invoices and if possible, these invoices should be traced back to purchase requisition through receiving reports or goods received notes and purchase orders.

B. Vouching of purchases transactions

The auditor should vouch credit purchases in the following manner:

(i) **Examine purchase book:** The auditor should examine the transactions recorded in the purchase book with reference to related purchase invoice.

(ii) **Examine purchase invoices:** The auditor should select a small sample of vendors' invoices at random and should conduct in-depth audit on them i.e., trace the transaction from placing the order to the entries in inventory goods for actual receipt and payment made to the suppliers. In respect of imports, documents such as bill of lading, customs clearance, etc. should be examined. The auditor should ensure that subsidies, rebates, duty drawbacks or other similar items have been properly accounted for.

(iii) **Examine the numerical sequence of source documents:** The auditor should ensure the numerical sequence of source documents such as purchase requisitions, purchase orders, receiving reports and vouchers have been maintained and missing numbers have been duly accounted for.

(iv) **Examine cut off points:** In order to ensure that purchases were recorded at that point of time when title was passed to the client, the auditor should examine cut-off points on pre-numbered purchase requisitions, purchase orders and goods received notes. The auditor should, then, trace the goods received notes pertaining to a few days before the end of the period under audit to the related purchase invoices. Such a comparison would ensure that purchases represented by such invoices have been recorded as the purchases of the period under audit.

(v) Examine transition with related parties carefully.

C. Analytical procedures

The auditor should compare item-wise and location-wise both quantity and value of purchases for the current period with the corresponding figures for the previous period and ensure that major variations are explained and justified. Various analytical ratios should also be calculated and compare.

Question 13

How will you vouch and verify "Goods sent out on Sale or Return Basis".

(5 Marks, November, 2009)

Answer

Goods sent out on sale or return basis

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) See that price of such goods is unloaded from the sales account and the trade receivable's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.

(iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing inventory.

Question 14

Write short notes on "Cut-off arrangements". *(5 Marks, November, 2009)*

Answer

Cut-off arrangement: Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be 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 inventory are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and inventory. 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.

Question 15

Comment on the following situations:

On 31.12.2008, Amudhan Company Limited invested ₹45 lakhs in cumulative fixed deposits of Algar Bank Ltd. The deposits carry interest @10%per annum compoundable quarterly and amount of interest is added to the principal and is due and payable on the maturity date which is 5 years from the date of investments.

For the year ended 31st March, 2009, the company did not book any revenue of interest on the ground that interest amount is not available at their disposal till maturity date of investment.

(6 Marks, June, 2009)

Answer

Accrual Method of Accounting

(i) According to Section 128 of the Companies Act, 2013, books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies.

(ii) Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown under current assets in the balance sheet as per Schedule III Part I requirement.

(iii) As such, the profits and current assets are understated and true and fair view of the accounts are thus vitiated.

(iv) On considerations of materiality of the item, the auditor may appropriately decide to qualify the audit report.

Question 16

How will you vouch and verify the following:

(a) Production incentive paid to workers.

(b) Bad debt.

(c) Proposed dividend. *(5 Marks each, June, 2009)*

Answer

(a) Production incentive paid to workers

(i) The auditor should trace the total production incentive paid to workers from Statement of Profit and Loss to prime records/division wise/dept wise records.

(ii) The auditor should get the details of incentive scheme from the management and see that it is approved and updated by a competent authority.

(iii) The auditor should check the production figures from independent source and should correlate them with the incentive payment working computed by the accounts department.

(iv) He should check list of payment and also acquitted disbursement slips of select departments/periods for scrutiny of various data generated in the fields for their accuracy and completeness.

(v) The auditor should make an overall analytical procedure of ensuring the expense booked is commensurate in quantum with statistical data on production and strength of workers.

(b) Bad debts

(i) The amount of bad debts should be traced to the schedule of bad debts written off during the year.

(ii) Major amount of bad debts in the schedule be taken for scrutiny.

(iii) Check that the amount considered in write off had been overdue for long and scrutinize the correspondence files.

(iv) Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.

(v) The bad debts should be properly disclosed in Statement of Profit and Loss according to its materiality.

(vi) If provision had already been created for bad debts, see that to the extent of actual bad debts written off, the provision is released.

(c) Proposed dividend

(i) Proposed dividend is to be provided for even though it is proposed and is to be declared after the end of the accounting period in terms of AS 4 and also schedule III disclosure requirements.

(ii) The Auditor should check the minutes of the Board for the amount of dividend proposed to be considered for its declaration in general meeting.

(iii) The auditor should check the amount of paid up share capital and verify the quantum of dividend proposed by checking the calculations.

(iv) The interim dividend if any paid should be checked and ascertained that the proposed dividend is properly computed by adjustment to it, if the same had been reckoned for the total dividend.

(v) Dividend tax payable on proposed dividend should be provided for.

(vi) The account should be properly disclosed in Statement of Profit and Loss and also in balance sheet according to the requirements of AS 4 and Schedule III to the Companies Act, 2013.

Question 17

How will you vouch and verify the following:

(a) Insurance Claim. *(5 Marks, November, 2008)*

(b) Preliminary Expenses. *(5 Marks, November, 2008, 4 Marks, November, 2004)*

(c) Customs Duty. *(5 Marks, November, 2008)*

Answer

(a) Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims:

(i) The auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen.

(ii) The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy.

(iii) The copy of certificate/report containing full particulars of the amount of loss should also be verified.

(iv) The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against asset, the Statement of profit and loss is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the Statement of profit and loss should be appropriately described.

(b) Preliminary expenses: The auditor takes following steps to vouch/verify preliminary expenses:

(i) All such kind of expenses should be related to the formation of the enterprise.

(ii) With all preliminary expenses, relevant supporting documents should be there.

(iii) He should examine company's minute's book to determine the pattern of writing off of the preliminary expenses over the period.

(iv) He must check that if such kinds of expenses are incurred by the promoters or they have been reimbursed to the promoters, it is as per the instructions of the BOD and the powers in AOA.

(v) He should make a cross check of the amount of preliminary expenses with that of amount mentioned in the prospectus, statutory report and balance sheet.

(c) Custom Duty

(i) Examine the cash book to ensure payment of custom duty with reference to Bill of entry to check whether the amount was calculated correctly.

(ii) If the duty has been paid by clearing and forwarding agent, examine bill of entry with reference to agent's bill.

(iii) If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of custom duty.

(iv) Make a list of disputed cases to have knowledge of the amount of duty payable and the provisional payment. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.

(v) Lastly, the auditor verifies the duty drawback.

Question 18

How will you vouch and verify Sale of Scrap. *(5 Marks, May, 2008)*

Answer

Sale of scrap:

(i) Review the internal control as regards generation, storage and disposal of scrap.

(ii) Check whether the organization is maintaining reasonable record for generation of Scrap.

(iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.

(iv) Check the rates at which scrap has been sold and compare the rate with previous year.

(v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.

(vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.

(vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

Question 19

How will you vouch and verify Recovery of Bad Debts written off.

(5 Marks, November, 2007,4 Marks, May, 2004)

Answer

Recovery of bad debts written off

(i) Ascertain the total amount of bad debts.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from trade receivables should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(v) Vouch acknowledgement receipts issued to account receivables or trustees.

Question 20

State with reasons (in short) whether the following statements are True or False:

(a) Cut-off procedures are generally applied to trading transactions.

(b) An unexplained decrease in the Gross profit ratio may result due to fictitious sales.

(2 Marks each, May, 2007)

Answer

(a) True: They cover the areas of purchases, sales, inventories to ensure that transaction of one year do not get recorded in the following year or preceding year to ensure 'matching' and true and fair view of the accounts.

(b) False: A fictitious sale will increase the gross profit ratio instead of decreasing it. G.P. Ratio normally comes down if there are unrecorded sales or fictitious purchase or decrease in closing stock.

Question 21

How will you vouch and verify the following:

(a) Rental Receipts.

(b) Cash Sales. *(5 Marks each, May, 2007)*

Answer

(a) Rental Receipts

(i) Check copies of bills or rent receipt issued to the tenant with reference to tenancy agreement and bills of charges paid by the landlord on behalf of tenants.

(ii) The entries in the rental register in respect of rent accrued should be traced with reference to copies of rental bills.

(iii) Scrutinize the account of collecting agent when the rent is collected by such agent.

(iv) Vouch the entries for rent received in advance and ensure proper adjustment is made.

(v) Investigate into abnormal rent outstanding.

(vi) Reconcile the outstanding rent and see that proper provision is made if unrecoverable.

(vii) If rent is received net of TDS, see that rent income is shown at gross and TDS is shown in Balance Sheet as advance Tax.

(b) Cash Sales

(i) Examine the system of internal check to ascertain any loopholes therein.

(ii) Ascertain the practice followed in the matter of issuing cash memos and trace the memos into cash sale summary.

(iii) Ensure that the date of cash memos tally with the entry in the cash book/summary.

(iv) Verify that prices of goods sold have been correctly recorded and check the calculation.

(v) Verify the entry in the goods outward book with the sales summary.

(vi) See that the cancelled cash memos are not removed from the receipt book.

Question 22

What is meant by external confirmation? Mention four situations where external confirmation may be useful for auditors. *(6 Marks, November, 2006)*

Answer

External Confirmations: SA 505, "External Confirmations", lays down standards for external confirmation of balances. As per the Standard, External Confirmation means audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

SA 500, "Audit Evidence", indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained[1]. That SA also includes the following generalisations applicable to audit evidence[2]:

(i) Audit evidence is more reliable when it is obtained from independent sources outside the entity.

(ii) Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.

(iii) Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. SA 505 is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

Following are the examples of situations where external confirmation may be useful.

(i) Bank balance & other information from bankers,

(ii) Accounts receivable balances,

(iii) Inventory held by third parties,

(iv) Property Title Deed held by third parties,

(v) Investments purchased but delivery not taken,

(vi) Loan from lenders,

(vii) Accounts payable balances,

(viii) Long outstanding share application money.

Question 23

How will you vouch and/or verify the following:

(a) Goods sent on Consignment.

(b) Expenditure on Foreign Travelling.

(c) Premium paid for insurance of a Motor car. *(4 Marks each, November, 2006)*

Answer

(a) Goods sent on consignment: Such transaction should be vouched and verified as under-

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[1]SA 500 (Revised), paragraph A5.

[2]SA 500 (Revised), paragraph A31.

(i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.

(ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

(v) See that goods in hand with the consignee have been shown distinctly under inventories.

(b) Expenditure on foreign traveling:

(i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.

(ii) Verify that the tour programme was properly authorised by the competent authority.

(iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.

(iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.

(v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(c) Premium paid on Insurance of a Motor Car:

(i) Check insurance cover note issued by the Insurance Company. Verify car no., period of Insurance coverage etc.

(ii) Verify that "No claim Bonus" is given, where entitled, by the Insurance Company.

(iii) Ensure that proper adjustment is made for pre-paid insurance premium.

Question 24

While conducting the audit of accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply decreased in comparison to the previous year. State the steps you would take to satisfy yourself. *(12 Marks, November, 2006)*

Answer

Decrease in rate of Gross Profit on Sales: When rate of Gross Profit on Sales of a manufacturing company has sharply decreased in comparison to the previous year, the auditor should satisfy the reasons for the same. Following factors should be considered which might cause decrease in the Gross Profit of the manufacturing company:

(i) Undervaluation of closing inventory or overvaluation of opening inventory either due to wrong valuation of inventory or mistake in inventory taking .

(ii) Change in the basis of inventory valuation. For example, opening inventory was valued at market price above cost when closing inventory valued at cost which is below the market price.

(iii) Inclusion in the current year, the amount of goods purchased in the previous year, that were received and taken in the same year.

(iv) Reversal of fictitious sale entries recorded in the previous year to boost up profit.

(v) Sales return entry passed two times or entry for purchase return has not been passed whenever goods are returned to suppliers.

(vi) Excess provision for wages or direct expenses have been made.

(vii) Goods sent out for sale on approval or on a consignment basis not included in closing inventory.

(viii) Value of unusual inventory of consumable stores (fuel and packing materials) are not shown as inventory or not adjusted from corresponding expenses.

(ix) Expenses which should be charged in the in Profit and Loss Account but wrongly charged to the Trading Account.

(x) Insurance claim received in respect of goods lost in transit or destroyed by fire, not credited in Trading Account.

(xi) Goods sold or given as samples or destroyed, not accounted for.

Question 25

As an auditor, comment on the Travelling expenses of ₹ 2.25 lakhs shown in Profit and Loss Account of X Ltd., including a sum of ₹ 1.10 lakhs spent by a Director on his foreign travel for company's business accompanied by his mother for her medical treatment *(5 Marks, May, 2006)*

Answer

Personal Expenses Charged to Revenue Account: As per the provisions of Section 143(1) of the Companies Act, 2013, the auditor shall enquire whether personal expenses have been charged to revenue account and make a report to the members in case he is not satisfied with the answer.

In this case, the auditor should examine documentary evidence in support of the travelling expenses of ₹ 1.10 lakhs incurred by the director and ascertain the personal component thereof. Then he should enquire as to whether such personal expenses incurred by the company are covered by contractual obligations or by any accepted business practices. In case, the answer is negative, the auditor should make a report thereon and qualify his audit report.

Question 26

How will you verify/vouch "Purchase return"? *(4 Marks, May, 2006)*

Answer

Purchase Returns:

(i) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.

(ii) Verify by reference to relevant corresponding record in good outward book or the stores records. Further, the figures in these documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.

(iii) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.

(iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

Question 27

Write short notes on "Scrutiny of General Ledger". *(4 Marks, May, 2006)*

Answer

Scrutiny of General Ledger:

(i) The General Ledger contains all the balances which are ultimately included in the Statement of Profit and Loss and the Balance Sheet. Its examination, therefore is undertaken last of all.

(ii) The scrutiny of General Ledger should be carried out with due care in as much as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.

(iii) Entries in the General Ledger usually are posted in a summary form from the books of original entries such as Cash Book, Journal, Sales Book, Purchase Book and other subsidiary books. Therefore, it should be confirmed that all the postings on various accounts have been verified, totals, etc. checked.

(iv) It should also be ascertained that balances in all the income and expense accounts have been adjusted: (a) according to standard accounting practices (i.e., all unpaid, prepaid expenses have been adjusted and accrued Income and prerecorded income is properly adjusted; and (b) on a consideration of the legal provisions which are applicable to the concern.

(v) The balances in the General Ledger should be traced to the trial balance and from the trial balance to the final accounts.

Question 28

How will you vouch and/or verify the following:

(a) Sales Commission Expenditure.

(b) Sales Return. *(4 Marks each, November, 2005)*

Answer

(a) Sales Commission Expenditure

(i) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes the commission should be in accordance with the terms and conditions as specified.

(ii) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.

(iii) Ensure that the sales in fact have taken place and the same has been charged to Statement of profit and loss.

(iv) Compare the amount incurred in previous years with reference to total turnover.

(b) Sales Return

(i) Examine the accounting basis for such transactions with reference to corresponding Debit Note to Debit Note. The relevant correspondence may also be examined.

(ii) Verify by reference to relevant corresponding record in good inward book or the stores records. Further, the figures in these documentary evidences should be compared with the original invoices for rates and other charges and calculation should also be checked.

(iii) Examine in depth to eliminate the possibility of fictitious sales returns for covering bogus sales recorded earlier when such returns outwards are in substantial figure either at the start or end of the accounting year.

(iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.

Question 29

Write short notes on "Vouching". *(4 Marks, November, 2005)*

Answer

Vouching: The act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transaction recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of transaction on its inclusion in the final statements of account. After examination, each voucher is marked in a manner to ensure that it may not be presented again in support of another entry. The following points need careful consideration while examining a voucher:

(i) that the date of the voucher falls within the accounting period;

(ii) that the voucher is made out in the client's name;

(iii) that the voucher is duly authorised;

(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and

(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

Question 30

How will you vouch and verify Wages paid to seasonal labourer. *(4 Marks, May, 2005)*

Answer

Wages Paid to Seasonal Labourers

(i) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.

(ii) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.

(iii) Ensure that the attendance is properly checked by the Time Keeping Department.

(iv) 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.

(v) Check the computation of wages payable to the labourers, after taking into account the deductions.

(vi) Confirm that all the payments to the labourers have been acknowledged.

(vii) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.

(viii) 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.

Question 31

How will you vouch and/or verify Personal expenses of directors met by the company.

(4 Marks, November, 2004)

Answer

Personal Expenses of Directors:

(i) Check the articles of association, service contract, minutes of general meeting, etc., to check the authorisation for such payment.

(ii) Enquire to ensure that personal expenses are not camouflaged in any other revenue items as contemplated under section 143(1) of the Companies Act, 2013.

(iii) Ascertain compliance with disclosure according to requirements of Schedule III to the Companies Act, 2013.

(iv) Check documentary evidences to examine the payments reimbursed.

Question 32

While conducting the audit of the accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply risen in comparison to the previous year.

State the steps you would take to satisfy yourself. *(12 Marks, November, 2004)*

Answer

Increase in the rate of gross profit on sales: There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that of the previous year, the most likely causes are as under:

(i) **Increase in Sales Prices:** The selling price of the finished products may have been increased. Enquiries should be made by auditor as to whether there have been general or specific price increase and the reasons for the same. The auditor should obtain copies of the company price lists prevailing at different point of time and make the relevant comparison.

(ii) **Reduction in Cost of Manufacturing:** The cost of manufacturing may have reduced substantially. The auditor should examine the inventory and purchases records in respect of large purchases of raw materials, comparing current costs with those in the previous year and detailed information supporting the possibility should be sought from the company.

(iii) **Alteration in Sales-mix:** The mix of sales may have been altered, resulting in the sales of more profitable items. Detailed sales analysis should be made for the period in order to ascertain whether the more profitable lines constituted a large proportion of the total sales.

(iv) **Impact of Automation:** The mechanisation or automation of certain manufacturing processes may have resulted in considerable saving in labour cost and this possibility could be easily verified by comparisons of wages records.

(v) **Adherence to Cut-off Procedures:** The company cut-off procedures as regards closing inventory and work-in-progress should be investigated, as any change in the procedure as compared with the previous year would cause a difference in the gross profit ratio. It should also be seen that the procedure laid down has been observed by the concerned personnel and rightly adhered to. The auditor should test relevant transaction and ensure that everything is incorporated in the financial statement.

(vi) **Manipulating Sales:** The possibility of items which have been sent to customers on 'sale or return' basis being included in sales, should be investigated, as this would give effect for increase in the rate of gross profit.

Question 33

Give your comments on "it is not essential to verify the sale proceeds of scrap which did not have a significant value if the company had a good accounting and costing systems".

(4 Marks, May, 2004)

Answer

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

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

Question 34

How will you vouch and/or verify Excise Duty. *(4 Marks, May, 2004)*

Answer

Excise Duty: Excise duty is levied on manufacture. The liability for duty arises only at the point of time at which manufacturing is complete. The point of time at which duty is collected may be determined by consideration of administrative convenience. Normally excise duty is paid before the issue of excisable goods from the factory. For this, the auditor should take into consideration:

(i) Ensure that excise duty is paid at the time of issue of excisable goods from the godown at factory of the producer. The duplicate copy of the challan as issued by the bank is forwarded for the purpose of issue of the excisable goods.

(ii) Verify the amount of duty paid with the corresponding value of the goods issued from the inventory register of the producer by applying test check. In case where the client maintains an advance deposit with Excise Department, the auditor should see that the permits are issued for delivery of the goods against the advance deposit and corresponding adjustment.

(iii) Ascertain the rates of excise duty and apply it to the total sales and see that the amount actually paid does not exceed the amount thus calculated.

(iv) Ascertain that in case of dispute about the amount of duty payable, a provisional amount may be paid in lieu of final amount. In such cases, the final amount determined as payable should be verified. If the provisional payment was more than the actual amount, the refund of such excess amount should be vouched.

(v) The auditor may also physically verify RG 1 with actual and see reconciliation of financial records with sales tax records.

6

Verification of Assets and Liabilities

Question 1

How will you vouch and verify the following?

(a) Assets acquired on hire purchase. *(4 Marks, November, 2013, 5 Marks, May, 2007)*

(b) Patterns, dies, loose tools etc. *(4 Marks, May, 2013)*

(c) Work-in-Progress. *(4 Marks, May, 2013, 5 Marks, May, 2008)*

Answer

(a) Assets acquired on Hire purchase

(i) Examine the Board's Minute book approving the purchase on Hire Purchase terms.

(ii) Examine the Hire Purchase Agreement carefully and note the description of the machinery, cost of machinery, hire purchase charges, terms of payment and rate of purchase.

(iii) Assets acquired under Hire Purchase system should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest.

(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.

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

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

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

(c) Work-in-Progress: The audit procedures regarding work-in-progress are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. The auditor may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date. Cost sheets of work-in-progress should be verified as follows:

(i) Ascertain that the cost sheets are duly attested by the works engineer and works manager.

(ii) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost sheets by reference to the records maintained in respect thereof.

(iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimate of cost expected to be maintained.

(iv) Ensure that the allocation of overhead expenses had been made on a rational basis.

Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.

(v) Ensure that the Work-in-Progress as at Balance Sheet date has been appropriately disclosed in Balance Sheet as per the requirements of Part I of Schedule III to the Companies Act, 2013.

Question 2

Write short notes on the following:

(a) Verification of issue of sweat equity shares. *(4 Marks, November, 2013)*

(b) Impairment of Assets. *(4 Marks, May, 2013)*

(c) Preliminary Expenses. *(4 Marks, May, 2012)*

Answer

(a) Verification of Issue of Sweat Equity Shares: As per section 54 of the Companies Act, 2013, 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 is authorised by a special resolution passed by the company;

(ii) the resolution specifies the number of shares, the 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 such issue, elapsed since the date on which the company had commenced business; and

(iv) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

(b) Impairment of Assets: Besides charging annual depreciation on assets by the reason of normal wear and tear, effluxion of time and obsolescence to reinstate the correct value of the assets considering the future cash flows that the assets can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as impairment loss. The treatment of impairment loss is similar to depreciation except the fact that it can be reinstated in future, if the recoverable amount of the asset exceeds the carrying amount.

The auditor must ensure that provisions of AS 28 "Impairment of Assets" are followed.

(c) Preliminary Expenses: This term is applied to expenses incurred in connection with the formation of a limited company. They generally include the following expenses:

(i) Legal costs in drafting the memorandum and articles of association;

(ii) Capital duty and other fees on registration of the company;

(iii) Cost of printing the memorandum and articles of association;

(iv) Cost of statutory books and the companies seal, etc; and

(v) Any other expense incurred to bring into existence the statutory books of the company.

If preliminary expenses incurred by promoters have been reimbursed to them by the company, the resolution of the Board of Directors and the power in the Articles to make such re-imbursement should be seen. The bills and statements supporting each item of preliminary expenses should be checked. It should be seen that no expenses other than those which constitutes preliminary expenses are booked under this head. The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet. Any amount paid in excess of the amount disclosed in the prospectus should have been approved by the shareholders.

Question 3

Comment on the following:

(a) Company can provide lower rate of depreciation than prescribed by Schedule XIV of the Companies Act, 1956. (2 Marks, May, 2013)

(b) What procedure an auditor should adopt to test the authenticity of cash at bank.

(5 Marks, November, 2011)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) **Verification of Cash at Bank:** While testing the authenticity of cash at bank, the following areas may be considered by the auditor:

(i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) The auditor should examine the possibility, that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

(vi) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

(vii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(ix) Where material amounts are held in bank accounts which are blocked, e.g. in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(x) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

Question 4

Discuss on the following:

(a) Purposes of providing depreciation. (5 Marks, November, 2012)

(b) Distinguish between Reserves and Provisions.(5 Marks, May, 2012) (5 Marks, May, 2007)

Answer

(a) Purposes of Providing Depreciation: The main purposes of providing depreciation are as under:

(i) To keep intact the capital invested in fixed assets - This is accomplished by retaining the amount of depreciation charged in the statement of Profit and Loss in the business.

(ii) To ascertain the true cost of production - As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.

(iii) To determine the profit or loss for the year - Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the Statement of Profit and Loss for determining the profit or loss during a year.

(iv) To present a true and fair value of entity's assets in the balance sheet, since the original costs of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the Statement of Profit and Loss representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.

(b) Reserves and Provision

(i) Reserve is an appropriation of profit whereas provision is a charge against Profit.

(ii) Reserves are not intended to meet any liability, contingency or diminution in the value of assets. Provisions are made to provide for depreciation, renewal or a known liability or a disputed claim.

(iii) Reserves cannot be created unless there is a profit except revaluation reserve and capital subsidy. Provisions must be created whether or not there is profit.

(iv) Reserves are generally optional except in certain situations – Capital Redemption reserve, Debenture Redemption Reserve etc. Provisions are not optional and have to be made as per generally accepted accounting principles.

(v) Reserves are shown on the liability side. Provisions for depreciation and provision for doubtful debts are shown as deduction from respective assets. Provision for liability is shown on the liability side.

Question 5

You are the auditor and examining the book debts of a company. Give some indications which leads to doubt about recovery as uncollectable debts from debtors and advances.

(8 Marks, May, 2012)

Answer

Indications of Doubtful and Uncollectible Debts: The term 'book debts' suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

The following are some of the indications of doubtful and uncollectible debts, loans and advances:

(i) The terms of credit have been repeatedly ignored.

(ii) There is stagnation or lack of healthy turnover in the account.

(iii) Payments are being received but the balance is continuously increasing.

(iv) Payments though being received regularly are quite small in relation to the total outstanding balance.

(v) An old bill has been partly paid (or not paid), while later bills have been fully settled.

(vi) The cheques received from the trade receivables have been repeatedly dishonoured.

(vii) The debt is under litigation, arbitration, or dispute.

(viii) The auditor becomes aware of unwillingness or inability of the trade receivable to pay the dues, e.g., a trade receivable has either become insolvent, or has closed down his business, or is not traceable.

(ix) Amounts due from employees, which have not been repaid on termination of employment.

(x) Collection is barred by statute of limitation.

Question 6

Disclosure requirements of debtors in the financial statements. (5 Marks, November, 2011)

Answer

Disclosure Requirements of Trade Receivables in Financial Statements: Note 6(P) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Trade Receivables" in notes to accounts as follows:

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Question 7

Write short notes on the following:

(a) Audit of sale of Investments.

(b) Verification of assets acquired on lease. (4 Marks each, November, 2011)

Answer

(a) Audit of Sale of Investments:

(i) See that sale of investment has been made on the proper authorisation of Board or other competent authority.

(ii) Ascertain the method of selling investments. It may be either through broker, directly or through a bank. See the broker's sold note.

(iii) See that the difference between the carrying amount and the sales proceeds, net of expenses, is recognised in the Statement of Profit and Loss. Ensure that when only a part of the holding of an individual investment is sold, the carrying amount is allocated on the basis of average carrying amount of the total holding of the investments.

(iv) See that proper disclosures as required by AS 13 are made as follows:

(1) Interest, dividends, rentals on investments are to be shown in Statement of Profit and Loss at Gross Value and TDS as advance tax paid.

(2) Showing separately profit & Loss on disposal and changes in carrying amount of current and long term investments.

(b) Verification of Assets acquired on Lease:

(i) Examine the terms and conditions of the lease deed.

(ii) If a part of the leasehold property has been sublet, examine the tenant's agreement.

(iii) Verify relevant document to check the cost of property.

(1) In case of acquisition of an asset is on operating lease, lease payment should be recognized as an expense in the Statement of Profit and Loss on a straight line basis over the lease term, in case of operating lease;

(2) In case of acquisition of an asset is on finance lease, ensure all the substantial risks and rewards to ownership are transferred, considering the indication as prescribed in AS-19, the lessee should recognize the lease as an asset and as a liability. Such recognition should be at an amount equal to the fair value of the leased assets at the inception of the lease. Ensure contingent rents are recognized as expense in the statement of profit & loss for the period in case of Finance lease.

(iv) Ensure assets acquired under finance lease are segregated from the assets owned.

(v) Ensure that the assets under lease have been properly disclosed as per requirement of Schedule III to the Companies Act, 2013.

Question 8

Define depreciation and discuss various purposes of providing depreciation.(8 Marks, May, 2011)

Answer

Depreciation Definition : According to AS-6 "Depreciation Accounting" issued by the Institute of Chartered Accountants of India, "Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, obsolescence through technology and market charges. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose usefulness is predetermined".

The term "depreciable amount" of a depreciable asset as per the standard is its historical cost, or other amount substituted for historical cost in the financial statements less the estimated residual value.

The accounting standard recommends that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

Purpose of Providing Depreciation:

(i) **To keep capital intact**: It will be evident that one of the effects of providing for depreciation on an asset is to retain an amount (equal to the proportion of the cost of the asset employed in the business that has run off, estimated on the basis of the period of its working life and its scrap value) in the business out of the profits in each year.

(ii) **To ascertain cost accurately**: Unless a proper charge on account of depreciation is included in the Statement of Profit and Loss, the true cost of manufacture of different products will not be ascertained. This is because depreciation is as much a charge against revenue as any other expenditure and must be included in accounts irrespective of the fact whether the final result of a working is profit or loss.

(iii) **To charge initial costs against earnings** : The cost of a machine less its scrap value can, in effect, be regarded as the price for use of the machine paid in advance for the period it will be rendering service. According to this view unless an appropriate part of this price is charged to the profits of the business each year, the profit earned on its working will not be correctly ascertained.

(iv) **To prepare true and fair statements**: Unless depreciation is provided, the assets will be shown at an amount higher than their true value and the profit shown will be more than the real profit. In other words, the Balance Sheet and the Statement of Profit and Loss will not be true and fair.

Question 9

State with reasons (in short) whether the following statements are True or False:

(i) A company can not declare dividends without providing for depreciation.

(ii) The Investments made by the company in Government Securities like NSC, Government Bonds, etc. should be kept in personal custody of Financial Controller of the Company.

(2 Marks each, May, 2010)

Answer

(i) True: On account of the provisions under Section 123 of the companies Act, 2013, no dividend shall be declared except out of profits arrived at after providing for depreciation in accordance with the provisions of the Act. It has become obligatory for every company distributing dividend to make a provision for depreciation.

(ii) False: There should be existence of a proper system for safe custody of all the securities with adequate internal control measure and documentation.

Question 10

State the information to be disclosed in the financial statements according to the requirements of AS 6. *(5 Marks, November, 2009)*

Answer

Requirements of AS 6: AS 6 requires following information to be disclosed in the financial statements:

(i) Historical cost or other amount substituted for historical cost of each class of depreciating asset;

(ii) Total depreciation for the period for each class of assets;

(iii) The related accumulated depreciation.

It also requires following disclosure of information in the financial statements along with the disclosure of other accounting polices:

(i) Depreciation method used and

(ii) The useful life of the assets for computing depreciation, if any, if they are different from the life specified in the Schedule.

Question 11

How would you vouch/verify the following:

(a) Leasehold Property. *(5 Marks, November, 2009)*

(b) Bank Overdraft. *(5 Marks, November, 2009)*

(c) Goods lying with third party. *(5 Marks, June, 2009)*

Answer

(a) Lease Hold Property: Following are the main steps involved in verification/vouching of lease hold property:

(i) Inspect the lease agreement to ascertain the amount of premium, if any, for securing the lease and terms and conditions. A lease exceeding the period of one year is not valid unless it has been registered by an instrument. Hence this has to be ensured.

(ii) Ascertain that all the conditions, the failure of which may result in cancellation of the lease have been complied with, e.g. payment of ground rent, insurance premium, maintenance of lease and property in satisfactory state etc.

(iii) Ensure that due provisions for any claims that might arise under the dilapidation clause on the expiry of the lease have been made. If such provision has not been made, the auditor should draw the client's attention to it.

(iv) Ensure that the outlay and legal expenses incurred to acquire lease property have been capitalised. The property must be written off in such a way that it completely wipes off the asset at the end of the lease period.

(v) He should ascertain that the clause entitles the lessee to sub let any part of the leased property and ensure its proper compliance.

(b) Bank Overdraft

(i) The auditor should ensure that the facility of overdraft is authorised by the Board's resolution / partner's resolution.

(ii) Pursue the agreement with the bank and see whether the overdraft is clean or against hypothecation or pledge of company's property.

(iii) Verify the register of charges and ensure that the charge has been registered with Registrar of Companies.

(iv) Verify the rate of interest and other terms and conditions from the agreement.

(v) Verify the amount of overdraft from the books of accounts and compare it with the passbook.

(vi) If the overdraft is against hypothecation of assets like inventories, a certificate from the bank should be obtained.

(vii) If the overdraft is against hypothecation of assets or pledge of company's property, see that overdraft is properly shown under 'secured loans' and nature of security has been property disclosed.

(c) Goods lying with third party

(i) The auditor should check that the materiality of the item under this caption included in inventories.

(ii) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(iii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iv) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(v) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(vi) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vii) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(viii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

Question 12

State with reasons (in short) whether the following statement is True or False:

"The fixed deposit held with bank by a company is to be shown under the head investments in Balance Sheet as per the requirements of part I of schedule VI to the Companies Act, 1956".

(2 Marks, June, 2009)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 13

Comment on the following situation:

Sri Limited charged depreciation on its plant and machinery comprised in fixed assets at rates different from what had been specified in schedule XIV, to the Companies Act, 1956. The auditor insisted that the rates of depreciation adopted should be mentioned in the notes to the account, else, he would make qualification in his audit report. The Management of the company contended that there is no impact in profits due to its omission to disclose the fact and hence on considerations of principle of materiality, the auditor is wrong in mentioning this omission in his report by way of qualification. *(8 Marks) (Jun 2009)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 14

XYZ Ltd. has purchased plant and machinery costing ₹ 1 crore in the month of October, 2008 out of working capital limits sanctioned by Bank.

What are reporting requirements by Statutory Auditors of the Company in this regard, keeping in mind the provisions of CARO 2003. *(4 Marks, June, 2009)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 15

Write short notes on "Physical attendance by auditor during inventory taking".

(5 Marks, June, 2009)

Answer

Attendance at inventory taking

(i) The physical verification of inventory is the responsibility of the management. The auditor may find it appropriate to attend the inventory taking, if the inventory value is material in his opinion.

(ii) The extent of participation in inventory taking depends upon the internal control system prevailing, results of examination of inventory records and analytical review procedures.

(iii) When auditor attend inventory taking, he ensure that the instructions given for inventory taking is followed.

(iv) He test checks few items by himself for their existence and quantum. He selects to test high value items importantly.

(v) The physical conditions of inventory – like its age, deterioration, obsolescence etc., are looked into by auditor.

(vi) The auditor reviews stores records and notes down major discrepancies for reconciling them in a subsequent date.

(vii) The cut off arrangement is also looked into ensure that the entity accounts for inventory for which liability had been booked and excludes stick which had been sold.

Question 16

State with reasons (in short) whether the following statement is True or False:

Secret reserve strengthens financial position, hence they are allowed. (2 Marks, November, 2008)

Answer

False: A secret reserve is that whose existence is not disclosed on the face of the Balance Sheet. Its existence strengthens the financial position. However, in the light of Provisions Contained in Schedule III to the Companies Act, 2013, it is not allowed.

Question 17

As an Auditor how would you react to the following situation/comment?

In a company Fixed Assets have been revalued and there has been resulting surplus of ₹ 2,00,000, which is transferred to revaluation reserve. The Company has a Debit balance in Profit and Loss account ₹ 1,20,000 as accumulated brought forward losses. The company has adjusted this loss balance against Revaluation reserve. (8 Marks, November, 2008)

Answer

Treatment of Reserve created on Revaluation of 'Fixed Assets': The guidance Note on Treatment of Reserve created on Revaluation of 'Fixed Assets' advises that the accumulated losses must not be adjusted against revaluation reserve as it would amount to setting off actual losses against unrealized gains.

In the given problem ₹ 2 lakhs transferred to revaluation reserve is unrealized gain whereas ₹ 1.20 lakh being debit balance in Statement of Profit and Loss is actual accumulated loss. This loss cannot be adjusted from unrealized gain raised as revaluation reserve.

Question 18

How would you vouch/verify "Trade Marks and Copy rights". (5 Marks, November, 2008)

Answer

Trademark and Copyright: The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verify that renewal fee have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks were purchased, the cost includes purchase price and registration charges. If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost. The cost of trademarks and copyright should be amortized over the period of legal validity or useful commercial life, whichever is short. Where auditor finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue. AS 26 has suggested a useful life of 10 years unless and until there is clear evidence that useful life is longer.

Question 19

Write short note on "Impairment of Assets". *(5 Marks, November, 2008)*

Answer

Impairment of Assets: Besides charging annual depreciation on assets by the reason of normal wear and tear, affluxion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the assets can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as impairment loss. The treatment of impairment loss is similar to depreciation except the fact that it can be re-instated in future, if the recoverable amount of the asset exceeds the carrying amount.

The auditor must ensure that provisions of AS 28 "Impairment of Assets" are followed.

Question 20

State with reasons (in short) whether the following statements are True or False:

(i) Interest accrued but not due on "Secured loans" is required to be shown under appropriate sub-heads under the head "Secured loans".

(ii) The term 'fund' and 'reserve' can be used interchangeably. *(2 Marks, May, 2008)*

Answer

(i) False: As per Part-I, Schedule III to the Companies Act, 2013 interest accured but not due on secured loans is required to be shown through notes to accounts under the head "Other Current Liabilities".

(ii) False: The term 'fund' in relation to any reserve should be used only where such reserve is specifically represented by earmarked investments.

Question 21

How will you vouch and verify Borrowings from Bank. *(5 Marks, May, 2008)*

Answer

Borrowings from a bank: Borrowings from a bank may be either in the form of overdraft limits; or short term or medium term or long term loans. The audit procedures which an auditor may adopt are outlined below:

(i) Ensure that balance as per books of the client and the bank statement tally. In case of difference between the two amounts, reconciliation statement prepared by the client should account for reasons.

(ii) Examine whether borrowings from the bank have been duly authorized.

(iii) Examine documents to ensure that statutory requirements, if any, with regards to creation and registration charges have been met.

(iv) Examine the loan agreement and ensure that the terms therein have been duly complied with.

(v) Ascertain the purpose for which loan has been raised and examine whether end use of the funds have been accordingly made.

Question 22

Distinguish between Capital expenditure and Deferred revenue expenditure.

(4 Marks, November, 2007)

Answer

Distinction between capital expenditure and deferred revenue expenditure: They differ in the following manners:

(a) Capital expenditure result in acquisition of new fixed assets or increase in future benefits from existing fixed assets beyond pre-assessed level.

Deferred revenue expenditure are expenditure of a revenue nature which bring in future benefits without creating a tangible or intangible fixed assets or by way of improvement in the existing assets.

(b) Capital expenditure adds to the net worth of the concern.

Deferred revenue expenditure is not considered in calculating net worth.

(c) Capital expenditure is shown under the head fixed assets in balance sheet.

Deferred revenue expenditure is recognized as an expense in the year of incurring and therefore not shown in the Balance sheet.

Question 23

How will you vouch and verify the following:

(a) Trade Creditors. *(5 Marks, November, 2007)*

(b) Advances to suppliers. *(5 Marks, November, 2007)*

Answer

(a) Trade Creditors:

(i) 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.

(ii) Check posting in the bought ledger from books of prime entry.

(iii) Compare the balances in the schedule of trade payables with balances in bought ledger.

(iv) Compare the balances with the confirmation or statement of account received from trade payables.

(v) Pay special attention to long outstanding items and enquire about the reason thereof.

(vi) Verify subsequent payments and reversal entries in the bought ledger of year end entries.

(vii) See that trade payables are classified and shown in the balance sheet as per the requirement of Schedule III to the Companies Act, 2013.

(b) Advances to suppliers:

(i) Examine the bought ledgers to ascertain the debit balance of trade payables and trace the corresponding entry to the cash/bank book.

(ii) Obtain a schedule of advances to suppliers and verify it with balances in bought ledger.

(iii) Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.

(iv) Obtain/resort to direct confirmation procedure.

(v) Ensure proper classification in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.

(vi) Pay special attention to long outstanding advances and enquire about the reason thereof.

Question 24

How will you vouch and verify Contingent Liabilities.(5 Marks, May, 2007) (4 Marks, May, 2004)

Answer

Contingent liabilities: Accounting Standard (AS) 29 on 'Provisions, Contingent Liabilities and Contingent Assets', defines 'Contingent Liability' as a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or as a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made.

The auditor may take following steps to vouch or verify the contingent liabilities:

(i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.

(ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.

(iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.

(iv) Examine bank letters in respect of bills discounted and not matured.

(v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.

(vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.

(vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.

(viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

Question 25

State the different types of Analytical Review carried out in verification of inventories.

(6 Marks, May, 2006)

Answer

Analytical Procedures for Verification of Inventories: The auditor can adopt the following analytical procedures to verify the stock of inventories:

(i) Quantitative reconciliation of opening inventories, purchases, production, sales and closing inventories;

(ii) Comparison of closing inventory quantities and amounts with those of the previous year.

(iii) Comparison of the inventory turnover ratios for the current year with that of the previous year and with industry standards if available.

(iv) Comparison of the closing inventory (Raw materials, closing work-in-progress and finished goods are percentage of total inventories) with the corresponding figures of the previous year.

(v) Comparison of current year gross profit ratio of the previous year.

(vi) Comparison of actual inventory, purchase and sales figures with the budgeted figures if available.

(vii) Comparison of raw-material yield/wastage with previous year figures.

Question 26

How will you vouch and verify the following:

(a) Purchase of quoted investment.

(b) Discounted bill receivable dishonoured.

(c) Amount due to subsidiary companies. *(4 Marks each, May, 2006)*

Answer

(a) Purchase of Quoted Investment:

(i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., error cum-dividend/interest/right/bonus.

(ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.

(iii) Verify the amount paid towards purchase of investments.

(iv) Trace the amount in the cheque book counterfoils and bank statements.

(v) Obtain a schedule of investment from Management for physical verification at the year end.

(vi) Verify the investment certificate to confirm title.

(vii) Confirm compliance with statutory provisions such as 143(1) of the Companies Act, 2013.

(viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

(b) Discounted Bill Receivable Dishonoured:

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

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

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

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

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

(c) Amounts due to Subsidiary Companies:

(i) Examine whether the subsidiary company is authorized by its Memorandum of Association to advance the loan to the holding company.

(ii) Verify the interest rate at which the loan has been obtained and particulars of the security that has been furnished for confirming the amount of interest and disclosure of the charge in the Balance Sheet.

(iii) Inspect the documents executed by the holding company which constitute the basis of the loan and the provision in the Memorandum under which the loan has been raised.

(iv) Verify by reference to the Balance Sheet of the subsidiary company that the loan is duly reflected in the Balance Sheet as a loan due from the holding company.

(v) Amounts due to subsidiary companies may be on account of credit purchases at goods or services which should be verified with the relevant documentary evidences.

(vi) Confirm whether the provisions of section 189 of the Companies Act, 2013, where applicable have been complied.

Question 27

Write short notes on "General Principles of Verification of Assets". (4 Marks, May, 2006)

Answer

General Principles of Verification of Assets: Verification of assets is an important audit process. Primarily verification of assets is the responsibility of the management since the management is expected to have a greater intimate knowledge of the assets of the business as regards location, use, conditions, etc. than what an outsider might be able to acquire on their inspection.

It is not sufficient for the auditors only to verify correctness of the amount of assets shown in the balance sheet, he must verify them by actual inspection or otherwise and establish the existence of assets. Points requiring auditor's attention for verification are as under:

(i) Cost - In regard to assets, verification procedure need not generally be extended to determination of the correctness of costs and authority to incur costs unless the items concerned were purchased during the accounting period under review. In such cases the auditor should check the correctness of costs through normal vouching method. He should ensure that adequate distinction has been made between 'revenue' and 'capital' nature of costs.

(ii) Ownership - Where ownership of assets is evidenced by documents of title etc. as in the case of immovable property, a reference should be made to such documents. If the documents are held by third person the auditor should either obtain a certificate directly from that party or arrange to inspect them at the third party's place of business.

(iii) Valuation - It must be ascertained that all assets are valued in accordance with appropriate accounting policy. For the valuation made, the basis must be consistently applied, unless circumstances necessitated a change. Even then a disclosure is required for the change and its monetary effect.

(iv) Existence - Physical inspection should be done wherever possible. Where physical inspection is not possible, the possibility of obtaining indirect evidence be considered e.g. machinery imported held in customs godown or materials sent to subcontractor for job work or fabrication. In such circumstances certificating of such parties should be obtained and if considered necessary even physical verification may be requested.

(v) Presentation in accounts - Material assets must be properly disclosed and correctly described in the accounts. It should be seen that the description given to them is clear and complete and is not misleading e.g. stating loans on the assets side of the balance sheet "as dependent upon realization" is just misleading as was held in the case of London and General Bank Ltd. care must be taken to see that disclosures required under the statute or statement issued by ICAI are complied with.

Question 28

As an auditor, comment on the following:

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. (4 Marks, November, 2005)

Answer

Verification of Inventories – Auditors' Duties: The audit procedures to be performed by an auditor to obtain sufficient appropriate audit evidence in relation to inventories have been recommended in the Guidance Note on Audit of Inventories issued by ICAI. 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 inventory-taking, examination of valuation and disclosure of inventories, carrying out analytical procedures, and obtaining confirmations from third parties and representations from the management.

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. It must be tested, for example, in case of inventory, physically verifying the same as to see that no discrepancy exists. Pilferage, misappropriation is not the only cause for discrepancies. Inherent product qualities like shrinkage, evaporation, handling loss, etc. may also account for discrepancies. The auditor should require the management to conduct physical verification by or near the year end. If the management does not accept to the auditor's view the auditor may appropriately make modification in his audit report.

Question 29

How will you vouch and verify the following:

(a) Stock lying with Third Party.

(b) Purchase of Motor Car. *(4 Marks each, November, 2005)*

Answer

(a) Stock lying with third party

(1) Obtain confirmations from the third party including the time period and reasons thereof.

(2) Evaluate condition of goods and see whether adequate provision has been made.

(3) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.

(4) Ensure that the goods have been included in the closing inventory though lying with third party.

(b) Purchase of Motor Car

(1) Ascertain whether the purchase of car has been properly authenticated.

(2) Check invoice of the car dealer to confirm purchase price.

(3) Examine registration with Transport Authorities to verify the ownership.

(4) Ensure that all expenses relating to purchase of car have been properly capitalized and the same have been disclosed properly in the balance sheet.

Question 30

Give your comments on "The CC Ltd., a Pharmaceutical Company, while valuing its finished stock at the year end wants to include interest on Bank Overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses". *(5 Marks, May, 2005)*

Answer

Cost of Inventories: As per Accounting Standard 2 "Valuation of Inventories", cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. However, it makes clear that interest and other borrowing costs are usually not included in the cost of inventories because generally such costs are not related in bringing the inventories to their present location and condition. Therefore, the proposal of CC Ltd. to include interest on bank overdraft as an element of cost is not acceptable because it does not form part of cost of production.

Question 31

How will you vouch and verify the following:

(a) Goodwill.

(b) Capital work-in-progress. *(4 Marks each, May, 2005)*

Answer

(a) Goodwill: Goodwill arises from business connections, trade name or reputation of an enterprise. AS 26, "Intangible Assets", states that internally generated goodwill is not to be recognised as an asset, as it is not an identifiable resource controlled by the enterprise, that can be measured reliably at cost. As per AS 10, "Accounting for Fixed Assets", goodwill should be recorded in the books, only when some consideration in money or money's worth has been paid for it. In light of the above discussions, the following points are to be noted for verification of goodwill:

(i) Examine the vendors' agreement on the basis of which assets of the running business have been acquired by the company as per the books of account or a specific amount has been paid for the goodwill.

(ii) Ensure that whenever business is acquired at a price, payable in cash or otherwise, which is in excess of the value of net assets taken over, such excess amount is the goodwill.

(iii) Ensure that only the amount paid to the vendors not represented by tangible or intangible assets, the value of which can be measured reliably has been debited to goodwill account.

(iv) See that goodwill has not been shown in the company's books by writing up the value of its assets, on revaluation, or by writing back the amount of good will earlier written off.

(v) Ensure that the goodwill not yet written off has been properly disclosed under the head "Fixed Assets" as per Schedule III requirements.

(vi) See that the goodwill is being amortised as per financial prudence over a reasonable period.

(b) Capital Work-in-Progress: Capital Work-in-Progress denotes assets under installation. This could either be plant or machinery under construction, or that construction project for establishment of a new factory is under progress. The auditor should take the following steps to verify the same:

(i) Ensure that the capital project is authorised by the Board. See the relevant Board Minutes for the purpose.

(ii) Obtain the break up in details of the amount shown in the Balance Sheet under this head.

(iii) Check purchase cost of plant machinery or other assets with reference to the contract with, and amount paid to the suppliers.

(iv) Examine the allocation of common costs to the Capital Work-in-Progress in case such items have been constructed internally.

(v) Ensure that the assets already put to commercial use are not included under Capital Work-in-Progress.

(vi) Verify that only expenses incurred up to pre commissioning stage are capitalised under this head.

(vii) Obtain the certificate of the engineering department to ascertain the quantum of the Capital Work-in-Progress, and whether the value is correctly represented in the Balance Sheet, and its transfer to Fixed Assets on completion of the projector installation of the plant.

(viii) See that Capital Work-in-Progress is properly disclosed in the Balance Sheet under the head Fixed Assets as per the presentation and disclosure requirements of Schedule III to the Companies Act, 2013.

Question 32

How will you vouch and verify the following:

(a) Patents.

(b) Advances given to suppliers. *(4 Marks each, November, 2004)*

Answer

(a) Patents:

(i) Obtain the schedule containing particulars of the patents owned by the client as on the balance sheet date. The particulars should contain the dates of registration of the patents with the related authorities and the dates in respect of the last renewal.

(ii) See that the total of the values of the patent rights shown in each list agree with the values shown in the respective ledger accounts.

(iii) Examine the cost of patent rights. In case of outright purchase of patent rights, the purchase consideration, legal fees and registration charges should be included in cost. When they are developed within the organisation, all costs incurred on their development including legal and registration expenses for registration of the patent should constitute the cost. Capitalised value should be amortised over the life of the patent.

(iv) See that the renewal fees in respect of the patent rights have been paid and the same has been treated as a revenue charge.

(v) Examine the valuation of the patent rights. It should be seen that the patent rights have been valued at cost less depreciation attributable to the expired legal life of the patent rights. However, if it is found that the patent rights have already lost substantial part of their commercial value, it would be proper to value it at their residual commercial value, when it is less than the book value for their unexpired legal life. In case the product covered by the patent rights does not have any sale value then patents should be shown at nil valuation notwithstanding any residual life. Reference to compliance with the provisions of AS 26 may also be made.

(b) Advances with the Suppliers:

(i) Obtain schedule of debit balances in trade payables' account and pay particular attention to the age of the balances. Also scrutinise the bought ledger.

(ii) Enquiry should be made for long unadjusted outstandings and check as to whether any of them would require provisioning.

(iii) Examine that the advances have not been shown as deposits in balance sheet as per section 143(1) of the Companies Act, 2013.

(iv) Confirmation of balances should be obtained and reconciliation be done in case of any discrepancies.

Question 33

Write short notes on "Disclosure requirements of bank balances of a limited company".

(4 Marks, November, 2004)

Answer

Disclosure Requirements for Bank Balance: As per Part I of Schedule III to the Companies Act, 2013, the disclosure of bank balances is under the head "Cash and Cash Equivalents" in Current Assets as:

(i) Balances with Banks.

(ii) Earmarked balances with banks (for example, for unpaid dividend).

(iii) Balances with banks to the extent held as margin money or security against borrowings, guarantees, other commitments.

Question 34

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

(a) The method of depreciation on Plant and Machinery is to be changed from SLM basis to WDV basis from the current year. (4 Marks, May, 2004)

(b) The Finance Manager of Belt Ltd. is of the opinion that before declaration of dividends it would not be necessary to set off the carried forward amount of debit balance in the Profit and Loss Account against current revenue profit but the same could be set-off against existing revaluation reserve. Do you agree? (5 Marks, May, 2004)

(c) The company has sent semi-finished goods to third parties for further processing which is lying with them at the end of the year. (4 Marks, May, 2000)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) Adjustment of Carried Forward Losses against Revaluation Reserves: The Guidance Note on "Treatment of Reserve Created on Revaluation of Fixed Assets" recommends that the accumulated losses should not be adjusted against such revaluation reserve, since this would amount to setting of actual losses against unrealised gains. However, in arriving at divisible profits, the provisions of Section 123 of the Companies Act, 2013 read with the Companies (Declaration and payment of Dividend) Rules, 2014 should be kept in view. The amount of loss or depreciation whichever is less should be set off against current revenue profit before declaration of dividends.

Since, mere revaluation of assets does not result in realised gain, and, thus, as per the sound accounting practice, the accumulated losses should not be adjusted against revaluation reserve because this would amount to setting off actual losses against unrealised gains. Therefore, if the debit balance in Statement of Profit and Loss is set off against revaluation reserve, and then dividend is declared from out of revenue profits, it would amount to payment of dividend out of capital without making good the amount of loss or depreciation whichever is less. Such a declaration will be violation of the provisions of Section 123 of the Companies Act, 2013. Hence, the opinion of the finance Manager of Belt Ltd. is not correct.

(c) Inventories lying with Third Parties: Semi-finished goods are the assets of the company and therefore such goods, though, at present not with the company, should be included in the closing inventory under the head "inventory with processors". The auditor shall be required to undertake the following steps in respect of inventories lying with third parties:

(i) Ensure that semi-finished goods have been included for valuation of inventory since these belong to the company.

(ii) Obtain confirmation letters from such third parties in respect of quantity lying with them at the end of the year. The auditor may also consider carrying out the appropriate audit procedure to obtain assurance about the condition of such inventory.

(iii) Examine the basis of valuation. In this case, it shall have to be done on the basis of the cost of work-in-progress and having regard to stage of completion and accordingly accounting for conversions costs.

(iv) Check that the disclosure requirements as specified in schedule III to the Companies Act, 2013 and AS 2, "Valuation of Inventories" have been followed.

Question 35

How will you vouch and verify Endowment Policies. *(4 Marks, May, 2004)*

Answer

Endowment Policies

(i) Ascertain the specific purpose for which the endowment policy is taken, e.g., Sinking Fund policies for redemption of debentures, redemption of leases or policies taken for other similar purposes, etc.

(ii) Verify the terms and conditions of policies and ensure that all such conditions are in force and being followed.

(iii) Check that premium has been deposited in time and the policy is in force.

(iv) Examine that proper disclosures have been made in the financial statements in respect of items for which the policy has been taken.

Question 36

Write short notes on the following:

(a) Intangible Assets

(b) Floating Charge. *(4 Marks each, May, 2004)*

Answer

(a) Intangible Assets: An intangible asset is that asset which does not have a physical identity but which is used by the enterprise for production or supply of goods or for retails to other or for administrative purpose. Such assets do not have any physical existence but their presence in the business is indicated with a value placed thereon. These assets include rights and benefit to owners subject to their being useful. For example: goodwill, patents, copyright etc. AS 26, "Intangible Assets", applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This standard also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. An intangible asset should be measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any impairment losses.

Auditor should also ensure that proper disclosure is made in the financial statements about the carrying amount, amortisation methods, useful lives, etc.

(b) Floating Charge: Floating charge refers to a general charge on some or all the assets of an enterprise which is not attached to any specific assets and is given as a security against a debt. It has the effect of creating an immediate charge on the property of the company leaving the company to deal with the same in the ordinary course of business, but subject to the limitations imposed in the instrument of creating the charge. The floating charge, however, becomes fixed or crystallised and the trade payable becomes entitled to proceed against the assets on which the charge was created, on violation of any of the terms of the instruments creating the charge. This charge is also required to be registered within 30 days of its creation under section 77 of the Companies Act, 2013.

7

The Company Audit- I

Question 1

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

(a) Rajat, an auditor recovers his fees on progressive basis is said to be indebted to company.

(b) The first auditor of PQR Ltd., a Government company was appointed by the board of directors of company.

(c) 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.

(d) Deviation in accounting policies are to be reported in auditor's report.

(e) Audit of Private Limited Companies are to be excluded while calculating ceiling on number of audits. (2 Marks each, November, 2013)

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. Section 139(6) of the Companies Act, 2013 (the Act) lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company". Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company. However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013. 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 auditor made by the Board of Directors of PQR Ltd., is null and void.

(c) 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 read with Guidance Note on Independence of Auditors.

In this case, Mr R is a "Tax Consultant" and not a "Statutory Auditor" or "Tax Auditor" of MN Ltd., hence he is not liable to disclose his relationship with Managing Director of the company.

(d) 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.

(e) Incorrect. As per section 141 (3)(g) of the Companies Act, 2013 Audit of Private Limited Companies are not excluded while calculating ceiling on number of audits.

Question 2

(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, November, 2013)

(b) Under what circumstances the retiring auditor can not be reappointed?

(6 Marks, November, 2013, 5 Marks, November, 2008)

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, 2013, sub-sections (1), (2), (3) (4) and (11) of Section 143 lays 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 141 of the Companies Act, 2013.

(iii) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.

(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 141(3)(g) of the Companies Act, 2013.

Question 3

Comment on the following:

(a) AGM is not held in time, auditor automatically vacates his office.

(b) ABC Ltd. having turnover of ₹ 100 crores during financial year 2011-12, need not get its branch audited whose turnover is ₹ 1.5 crores during the same year.

(c) CARO, 2004 does not apply to a foreign company. (2 Marks each, May, 2013)

Answer

(a) Tenure of Appointment: Section139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting. But in this regard it is to be noted that the company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.

In case the annual general meeting is not held within the period prescribed, the auditor will continue in office till the annual general meeting is actually held and concluded. Therefore, auditor shall continue to hold office till the conclusion of the annual general meeting. Auditor's office is not vacated automatically if AGM is not held in time.

(b) Branch Audit : As per section 143 (8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

Therefore, ABC Ltd. has to get its branch audited.

(c) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 4

(a) State the circumstances which could lead to any of the following in an Auditor's Report:

(i) A modification of opinion

(ii) Disclaimer of opinion

(iii) Adverse opinion

(iv) Qualified opinion (4 x 2 = 8 Marks, May, 2013)

(b) What are the cases in which special audit may be called by Central Government?

(4 Marks, May, 2013)

Answer

(a) (i) The auditor shall **modify the opinion** in the auditor's report when:

(a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

(ii) The auditor shall **disclaim an opinion** when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall **disclaim an opinion** when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

(iii) The auditor shall express an **adverse opinion** when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(iv) The auditor shall express a **qualified opinion** when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 5

Discuss on the following:

(a) Ceiling on number of audits in a company to be accepted by an auditor.

(5 Marks, November, 2012)

(b) Filling of a casual vacancy of auditor in respect of a company audit.

(5 Marks, November, 2012)

(c) In Joint Audit, "each Joint Auditor is responsible only for the work allocated to him".

(5 Marks, May, 2012)

Answer

(a) Ceiling on number of Audits: Section141 (3)(g) of the Companies Act, 2013 prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

(b) Filling of a Casual Vacancy: As per Section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within thirty days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within thirty days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within he said period the Board of Directors shall fill the vacancy within next thirty days.

(c) Responsibility of Joint Auditor: The principles governing to responsibilities of joint auditor are prescribed in SA 299, "Responsibility of Joint Auditor". As per SA 299, if joint auditors are appointed, they should divide the audit work among themselves by mutual discussion. The division of work would usually be in terms of audit of identifiable units or specified areas. Such division of work should be adequately documented and preferably communicated to the entity.

It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issue such as appropriateness of using test checks, sampling or other audit techniques should be decided by each joint auditor individually in relation to his work. Thus, the responsibility will not be shared by the other auditor. Therefore, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him.

Hence, in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. However, all the joint auditors are jointly and severally responsible in respect of the audit work which is not divided among the joint auditors and is carried out by all of them, in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors, in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors, for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute and for ensuring that the audit report complies with the requirements of the relevant statute.

Question 6

State any six basic elements of the Auditor's Report. *(6 Marks, November, 2012)*

Answer

Basic elements of the Auditor's Report: As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements, ordinarily, in the following layout:

(i) Title;

(ii) Addressee;

(iii) Introductory Paragraph

(vi) Management's Responsibility for the Financial Statements.

(v) Auditor's Responsibility

(vi) Auditor's Opinion

(vii) Other Reporting Responsibilities

(viii) Signature of the Auditor

(ix) Date of Auditor's Report.

(x) Place of signature

Question 7

Write short notes on "Auditor's lien". *(4 Marks, November, 2012)*

Answer

Auditor's Lien: In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property.

On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents.

Under section 128 of the Companies Act, 2013, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

SA 230 issued by ICAI on Audit Documentation also states that, "working papers are the property of the auditor". The auditor may at his discretion make portions of or extracts from his working papers available to his clients.

Thus, documents prepared by the professional accountant solely for the purpose of carrying out his duties as auditor (whether under statutory provisions or otherwise) belong to the professional accountant.

Question 8

(a) Discuss appointment of Auditor by special resolution. (6 Marks, May, 2012)

(b) State the matters which only the shareholders can sanction at a General Meeting.

(4 Marks, May, 2012)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) **Matters to be sanctioned only by the Shareholders:** Some of the matters which only the shareholders can sanction at a general meeting (List is not exhaustive):

(i) Appointment and fixation of remuneration of auditors in the annual general meeting - section 139 and 142 of the Companies Act, 2013.

(ii) Declaration of dividends - Regulation 85, Table A.

(iii) Entering into transactions with related party for such company and exceeding such sum as prescribed in the rules [first proviso to section 188(1) of the Companies Act, 2013].

(iv) Sale, lease or a disposal of the whole of the company's undertaking or a substantial part of it [Section 180(1)(a)].

(v) Donations above certain limit [Section 181]

Question 9

Discuss CARO 2003 requirement with regard to internal audit system. What are the factors to be considered by the auditor to examine whether the internal audit system is commensurate with the size of the company and the nature of its business? (8 Marks, May, 2012)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 10

Comment on "Removal of auditor before expiry of term". (5 Marks, November, 2011)

Answer

Removal of Auditor before Expiry of Term: According to Section 140 (1) of the Companies Act, 2013, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of Companies (Audit and Auditors) Rules, 2014:

(i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(ii) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

(iii) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

Question 11

What is Companies (Auditor's Report) Order 2003? Explain the companies which are not covered by the CARO order. (8 Marks, November, 2011)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 12

Explain the concept of joint audit. Discuss its advantage and disadvantage. (8 Marks, May, 2011)

Answer

Joint Audit: The practices of appointing chartered accountants as joint auditors is quite widespread in big companies and corporations, joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

When more than one auditor is appointed to audit large entities, such auditors are called joint auditors. Joint auditors have a collective responsibility to report on the financial statements. SA 299, "Joint Audit" deals with duties, rights and professional responsibilities of joint auditors. The joint auditors should follow the principles of division of work and coordination while conducting joint audits.

Advantages of Joint Audit:

(i) Pooling and sharing of expertise

(ii) Advantage of mutual consultation.

(iii) Lower work load

(iv) Better quality of work performance.

(v) Improved service to the client.

(vi) Displacement of the auditor of the company in a take-over often obviated.

(vii) In respect of multinational companies, the work can be spread using the expertise if the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(viii) Lower staff development costs.

(ix) Lower costs to carry out the work.

(x) A sense of healthy competition towards a better performance.

Disadvantages of Joint Audit:-

(i) The fees being shared.

(ii) Psychological problem where firms of different standing are associated in the joint audit.

(iii) General superiority complexes of some auditors.

(iv) Problems of coordination of the work.

(v) Areas of work of common concern being neglected.

(vi) Uncertainty about the liability for the work done.

(vii) Lack of clear definition of responsibility.

Question 13

Comment as an auditor on the following situations:

(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.

(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. *(5 Marks each, November, 2010)*

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) **Appointment of the Auditor:** As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding ₹ 5,00,000/- then he is not qualified for appointment as an auditor of a company.

Where an auditor purchases goods or services from a company audited by him whether in normal course of business, he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh, he is disqualified for appointment as an auditor of the company.

In such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

Conclusion: Accordingly, the partner Mr Sri is not disqualified to be appointed as auditor of the company as he is indebted to the company for an amount not exceeding ₹ 5,00,000.

Due to this, Sri & Co., is not disqualified to be appointed as an auditor of Aaradhana Company Ltd.

Question 14

Write short note on "Physical verification of fixed assets "at reasonable intervals".

(4 Marks, November, 2010)

Answer

Physical verification of fixed assets "at reasonable intervals": It is the duty of management to physically verify the fixed assets of the company at reasonable interval. "Reasonable Intervals" depends upon the circumstances of each case. The factors to be considered in this regard includes the number of assets, nature of assets, relative value of assets, difficulty in verifications, situation and spread of the assets etc.

The management may decide about the periodicity of physical verification of fixed assets considering the above factors while an annually verification may be reasonable; it may impracticable to carry out the same in some cases. Even in such cases the verification program should be such that all assets are verified at least once in every three years where verification of all assets is not made during the year, it will be necessary for the auditor to report the fact, but if he is satisfied regarding the frequency of verification, he should also make a suitable comment to that affect.

The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account.

It would be appropriate for the auditor to obtain a management representation letter confirming that the fixed assets are physically verified by the company in accordance with the policy of the company. The management representation letter should also mention the periodicity of the physical verification of fixed assets. The letter should also include the details of the material discrepancies noticed during the physical verification of the fixed assets. If no discrepancies were noticed during the physical verification, the management representation letter should also mention this fact.

Question 15

State briefly the circumstances when an auditor issues a disclaimer of opinion.

(4 Marks, November, 2010)

Answer

Disclaimer of Opinion: The auditor can express a disclaimer of opinion when the possible effect of a limitation on scope of the auditor's work is so material and pervasive that he has not been able to obtain sufficient and appropriate evidence and is accordingly unable to express an opinion on the financial statements. For example, when the books of account of the auditee company have been seized by Income tax/Excise authority, the auditor will be unable to express his opinion on the financial statements.

Similarly when the terms of engagement specify that the auditor will not carry out an audit procedure that the auditor believes necessary, the auditor may express disclaimer of opinion.

A scope of limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that he is unable to observe the counting of physical inventories.

It may also arise when in the opinion of the auditor the entity's accounting records are inadequate or when the auditor is unable to carryout an audit procedure believed to be desirable.

The resolution on certain matters dependent upon future events may also cause the auditor to make a disclaimer of opinion.

When there is a limitation on the scope of the auditor's work that requires disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

Question 16

Comment on the following:

X Ltd. has its Registered Office at Mumbai. During the current accounting year it shifted its Corporate Office to Delhi. The Managing Director of the Company wants to shift company's books of account to Delhi because he holds the view that there is no legal bar in doing so.

(4 Marks, November, 2010)

Answer

Shifting of Books of Account: As per section 128(1) of The Companies Act 2013, every company shall keep at its registered office proper books of accounts. It is permissible, however, for all or any of the books of accounts to be kept at such place in India as the Board of Directors may decide but, when a decision in this regard is taken, the company must file within seven days of such decision with the Registrar of Companies a notice in writing giving full address of the other place.

Conclusion: In view of the above provisions, X Ltd should maintain its books of account at its registered office at Mumbai. The Managing Director is not allowed to shift its books of account to Delhi unless decision in this behalf is taken by the Board of Directors and a notice is also given to the Registrar of Companies.

Question 17

PQR Company Ltd. removed their first auditor by passing a resolution in the meeting of the Board of Directors for his removal without obtaining prior approval from the Central Government.

Offer your comments in this regard. *(4 Marks, November, 2010)*

Answer

Removal of first Auditor: As per sub section (1) of Section 140 of the Companies Act, 2013, an auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the prior approval of the Central Government in that behalf as per Rule 7 prescribed under Companies (Audit & Auditors) Rules, 2014:

(i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(ii) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

(iii) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

Conclusion: In the instant case the first auditor appointed by the Board of Directors was removed by a resolution in the meeting of the Board of Directors inspite of the Special resolution of the Company as per the requirement of section 140(1) alongwith the prior approval of the Central Government in that behalf.

Due to contravention of the provision of sub section (1) of Section 140, the auditor should qualify the audit report.

Question 18

State with reasons (in short) whether the following statements are True or False:

(i) While conducting audit of Government Companies, the auditors are paid their Professional Fees as prescribed by the Government.

(ii) Audit Committee is to be formed by each and every company and the auditor has no compulsion to attend the meeting of the Audit Committee.

(iii) The auditor should study the Memorandum and Articles of Association to see the validity of his appointment.

(iv) The company in which 15% of subscribed capital is held by State Financial Corporation and 10% of Subscribed capital is held by General Insurance Co., the appointment of auditor can be done by passing a general resolution at annual general meeting.

(2 Marks each, May, 2010)

Answer

(i) False: As per section 142(1) of the Companies Act,2013 ,the fees of auditors of a company is fixed by the company in its general meeting or in such a manner as the company in general meeting may determine.

(ii) False: As per section 177 of the Companies Act, 2013 read with the Companies (Meeting of Board and its Powers) Rules, 2014, Audit committee is to be formed by every listed companies, all public companies with a paid up capital of ten crore rupees or more, all public companies having turnover of one hundred crore rupees or more, all public companies having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more. Further, the Auditor shall have the right to be heard in the meetings of the Audit Committee when it considers the Auditor's Report but shall not have the right to vote.

(iii) False: Memorandum of Association lays down the object to be carried on and Articles of Associations reflects the regulations of the company to govern its internal management and to regulate the rights of the members. Auditor should ascertain whether the company has complied with provisions of section 139 and 140 to ensure validity of his appointment.

(iv) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 19

Comment on the following situations:

(a) Mr. Y was appointed as an auditor of PQR Ltd. for the year ended 31.3.2009 at Annual General Meeting held on 16.08.2008. Mr. Y has been indebted to the company for sum of ₹ 10,000 as on 1.4.2008, the opening date of accounting year which has been subject to his audit. However, Mr. Y having come to know that he might be appointed as auditor, he repaid the amount on 10.8.2008. One of the shareholders, complains that the appointment of Mr. Y as an auditor was invalid because he incurred disqualification u/s 226 of the Companies Act, 1956. (6 Marks, May, 2010)

(b) XYZ (Pvt.) Ltd. has paid up Capital and Reserves of ₹ 60 lacs and secured Loans of Nationalized Banks having sanctioned limit of ₹ 28 lacs and outstanding balance of ₹ 23 lacs. The turnover of the company is 5.10 crores for the year ended 31.3.2009. A customer returns goods worth 40 lacs on 2.4.2009, out of sales made during the year ended 31.3.2009. The management of CO. is of the opinion that CARO, 2003 is not applicable to the company. (6 Marks, May, 2010)

(c) C Ltd. declared dividend amounting to ₹ 5 lacs out of Profits for the year ended 31.3.2009.

Subsequently, it was noticed that company had failed to make provisions for outstanding expanses of ₹ 7.80 lacs and closing stock was also over valued, which was not reported by auditors of the company. Management of C Ltd. helds auditors responsible for this situation. (8 Marks, May, 2010)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

(c) **Failure to detect untrue and incorrect financial position of a company**: In the given case, profit of the company has been inflated by non-provisioning of outstanding expenses of ₹ 7.80 lacs and by overvaluation of closing stock and based on such inflated profit the company has declared and paid dividend of ₹ 5.00 lacs. Thus it can be said that dividend has been paid out "inflated profit" and not out of "real profit". If there is insufficient profit after above adjustment of outstanding expenses and correction of stock valuation and there is no past reserve, it would amount to payment of dividend out of capital.

It was the duty of auditor to ascertain whether the Balance Sheet and Statement of Profit and Loss of the company show a true and fair view of the financial position and revenue earning capacity. For that he has to exercise proper audit procedure of substantive test (i.e. vouching and verification) and valuation of various items of Balance Sheet and Statement of Profit and Loss. The auditor should have checked whether all the outstanding expenses have been provided or not and whether closing stock has been properly valued as per AS-2. If he was not satisfied, he should have issued a qualified report or adverse report. In the instant case he has failed to do so, he will be guilty of gross negligence in the performance of his duty.

The facts of the case are similar to the established judgement on *"The Leeds Estate Building & Investment Co. Ltd vs Shepherd (1887)"*, where, it was held, that it was an auditor's duty to ascertain that the accounts, he certifies, are correct and that if he fails in his duty, he is liable for damages for dividends wrongly paid by the company out of capital.

Question 20

Differentiate between 'Qualified report' and 'Adverse report'. *(5 Marks, May, 2010)*

Answer

Distinction between Qualified report and Adverse report

(i) A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not so material and pervasive as to require a disclaimer of opinion.An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate, to disclose the misleading or incomplete nature of the financial statements.

(ii) In qualified report, the auditor's reservation is generally written as "subject to or except for, we report that the Balance Sheet shows a true and fair view". Whereas in case of adverse report, the auditor states that "the financial statements do not present a true and fair view of the state of affairs and working results".

(iii) In the qualified report, the auditor gives an opinion subject to certain reservations whereas in the case of adverse report the auditor concludes that on the basis of his examination he is not satisfied with the affirmation made in the financial statements.

Question 21

State with reasons (in short) whether the following statements are True or False:

(i) A casual vacancy caused by resignation of the auditor can be filled by the Board of Directors.

(ii) Comptroller and Auditor General of India can be removed by the Prime Minister of India on the recommendation of his Council of Ministers.

(iii) Provisions of Companies (Auditor's Report) order 2003 as amended upto date, apply to clubs, chambers of commerce, research institutes etc, which have been established under Section 25 of the Companies Act, 1956.

(iv) Mr. X, a Chartered Accountant, is an employee of M/s M & N Co., a firm of Chartered Accountants of India. The firm is the Auditors of ABC & Co. Ltd. After auditing the accounts of the Company the Auditor firm allowed Mr. X, their employee, to sign the audit report which he did.

(v) *The Auditor disagreed with the management with regard to the acceptability of the Accounting Policies and the inadequacy of disclosures in the financial statements and issued a disclaimer.* *(2 Marks each, November, 2009)*

Answer

(i) False: Casual vacancy caused by the resignation of an auditor cannot be filled in by the Board of Directors itself, such appointment shall also be approved by the company at general meeting convened within three months of the recommendation of the board and then he shall hold office till the conclusion of the next annual general meeting.

(ii) False: The Comptroller and Auditor General of India cannot be removed by the Prime Minister of India on the recommendation of his Council of Ministers. He can be removed on the ground of proven misbehaviour or incapacity, when each House of Parliament decides to do so by majority of not less than 2/3 of the members of the house present and voting.

(iii) This question is redundant in view of the provisions of the Companies Act, 2013.

(iv) False: An employee Chartered Accountant cannot sign the auditor's report on behalf of the auditing firm. Only a partner in the firm can sign the audit report in compliance with the provisions of Section 145 read with 141(2) of the Companies Act, 2013.

(v) False: The auditor is wrong in issuing a disclaimer. If the auditor disagrees with the management in the matters relating to the acceptability of Accounting Policies selected and inadequacy of the disclosures in the financial statements, he should issue a qualified report or express an adverse opinion.

Question 22

Comment on the following situations:

(a) *XYZ Ltd. Co. gave a donation of ₹ 50,000 each to a Charitable Society running a school and a trust set up for the service of Blind during financial year ending on 31st March, 2009. The average net profits of the company for the last three years were 15 lakhs.*

(8 Marks, November, 2009)

(b) *Mr. X, a shareholder of the company pointed out that:*

  (i) *The goodwill in the Balance Sheet of the company has appeared on same figure during the past three years.*

  (ii) *Premium received on issue of shares prior to the date of balance sheet has been transferred to Profit and Loss account for arriving at the figure of commission payable to the managing director.* *(6 Marks, November, 2009)*

(c) *A, B & C Company Ltd. removed its first Auditor before the expiry of his term without obtaining approval of the Central Government.* *(6 Marks, November, 2009)*

Answer

(a) Donation to Charitable Institutions: Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bona fide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed five per cent of its average net profits for the three immediately preceding financial years.

Facts of the case: In the instant case, the company has given donation of ₹ 50,000 each to the two charitable organisations which amounts to ₹ 1,00,000. Assuming that the charitable organisations are not related to the business of the company, the average profits of the last 3 years is ₹ 15 lakhs and the 5% of this works out to ₹ 75,000. Hence the maximum of donation could be ₹ 75,000 only. For excess of ₹ 25,000 the company is required to take prior permission in general meeting which is not been taken.

Conclusion: By paying donations of ₹ 1,00,000 which is more than ₹ 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. Hence the auditor should qualify his audit report accordingly.

(b) (i) **Disclosure of Intangible Assets in the Books of Accounts:** As per the provisions of AS 26 "Intangible Assets", an intangible assets should be carried in the books at cost less accumulated amortization and accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a reputable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use according to Para 63 of AS 26. In the given case, the company has not amortized any value of goodwill since past three years. The auditor should have indicated this fact in his report that no amount of goodwill has been written off during the past three years.

(ii) **Treatment of Premium received on issue of shares:** Premium received on issue of shares is capital receipt and should not credited to Statements of Profit and Loss. As per the provisions of Section 198 of the Companies Act, 2013, premium on issue of shares should not be considered in computation of net profit for the purpose of managerial remuneration. The auditor should have qualified the audit report and qualified the amount by which the profit stands inflated.

(c) Removal of first auditor: As per sub section (1) of Section 140 of the Companies Act, 2013, an auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the prior approval of the Central Government in that behalf as per Rule 7 prescribed under Companies (Audit & Auditors) Rules, 2014:

(i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(ii) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

(iii) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

Conclusion: In the instant case, the first auditor was removed by the company before the expiry of his term without obtaining approval of the Central Government inspite of the Special resolution as per the requirement of section 140(1) alongwith the prior approval of the Central Government in that behalf.

Due to contravention of the provision of sub section (1) of Section 140, the auditor should qualify the audit report.

Question 23

Comment on the following situation:

XYZ Co. Ltd. reappointed A and B as their joint auditors in the Annual General Meeting. The AGM authorised the Board for fill up the vacancy on their own in the event of both or either of auditors declined to accept the assignment. The Board passed a resolution to appoint C if any of the auditors declined to accept the assignment.

B declined to accept the assignment and Board of Directors appointed C in place of B as per its resolution. *(5 Marks, November, 2009)*

Answer

This question is redundant in view of provisions of the Companies Act, 2013.

Question 24

State with reasons (in short) whether the following statements are True or False:

(i) An auditor of a company in which not less than 25% of authorized capital is held by public financial institution is to be appointed by a special resolution in general meeting.

(ii) Disclaimer of opinion is issued when an auditor confronts a different stand by management in respect of a material issue which auditor does not approve of.

(2 Marks each, June, 2009)

Answer

(i) False: The auditor's appointment of such company should be made as per the provisions of the section 139 (1) of the Companies Act, 2013 i.e. Appointment of Auditor which does not require the special resolution in general meeting.

(ii) False: Disclaimer of opinion is issued when the auditor is unable to frame an opinion in view of certain reasons like non-availability of information, non-performance of procedure etc. Where the auditor is positively in disagreement with management on certain issue, he would issue qualified report.

Question 25

Comment on the following situations:

P, the first auditor of XYZ Ltd. resigned as auditors of the Co. Board of Directors appointed Mr. Q as statutory auditors in their place. (6 Marks, June, 2009)

Answer

Casual Vacancy on account of Resignation: As per Section 139 (8) of the Companies Act, 2013, in case the casual vacancy created on account of resignation, the Board of Directors will have to fill the vacancy within thirty days and such appointment shall be approved by the company at the general meeting within three months of the recommendations of the board. The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

Therefore, the casual vacancy created on account of resignation by Mr. P, cannot be filled in by the Board of Directors itself, such appointment shall also be approved by the company at general meeting convened within three months of the recommendation of the board.

Question 26

Write short notes on "Responsibilities of Joint auditors". (5 Marks, June, 2009)

Answer

Responsibilities of joint Auditors: SA 299 on Responsibilities of Joint Auditors require that joint auditors should by mutual discussion divide the audit work among themselves. It further states that each joint auditor is responsible only for the work allocated to him, whether or not he has prepared separate report on the work performed by him.

On the other hand, all joint auditors are jointly and severally responsible:

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

(ii) in respect of decision taken by all joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors;

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

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

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

Question 27

State with reasons (in short) whether the following statements are True or False:

(i) The auditor of a company is entitled to attend any General Meeting of the company as his duty.

(ii) An Auditor may be removed from Office before the expiry of his term, by the company in General Meeting.

(iii) C.A. Mr. X is the Auditor of PQ Ltd. In which one of his relative is having substantial interest, whether Mr. X is qualified to be an Auditor? (2 Marks each, November, 2008)

Answer

(i) False: It is partly true. The auditor of a company is entitled to attend any general meeting of the company and shall have the right to be heard at such meeting on any part of the business which concerns him as the Auditor but it is not his duty to attend or take part in the discussion.

(ii) False: As per Section 140(1), the auditor may be removed from the office before the expiry of his term by the company only by a special resolution and obtaining the prior approval of the Central Government.

(iii) False: CA Mr. 'X' is not qualified to be an auditor of P.Q. Ltd. as per CA amendment Act, 2006.

Question 28

Write short notes on the following:

(i) Disclaimer of Opinion.

(ii) Joint Audit. (5 Marks each, November, 2008)

Answer

(i) Disclaimer of Opinion: As per SA 500 "Audit Evidence", the auditor must collect sufficient and appropriate audit evidence, on the basis of which he draws his conclusion to form an opinion, on the financial statements. But, if the auditor fails to obtain sufficient information to form an overall opinion on the matter contained in the financial statements, he issues a disclaimer of opinion.

The reasons due to which the auditor is not able to collect the audit evidence are:

(i) Scope of audit is restricted.

(ii) The auditor may not have access to the books of accounts, e.g.:-

(a) Books of A/c's of the company seized by IT authorities.

(b) Sometimes, inventory verifications at locations outside the city bound the scope of duties of the auditor.

In such a case, the auditor must state in his audit report that-

"He is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion".

(ii) Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of SA 299, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. Further, it states that in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible:-

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

(b) In respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

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

(d) For examining that the financial statements of the entity comply with the disclosure requirement of relevant statute; and

(e) For ensuring that the audit report complies with the requirements of the relevant statute.

Question 29

State with reasons (in short) whether the following statements are True or False:

(i) An auditor can be appointed as first auditor of a newly formed company simply because his name has been stated in the Articles of Association.

(ii) CARO '2004 is also applicable to the audit of branch of a company, except where the company is exempt from the applicability of the order.

(iii) All the joint auditors are jointly and severally responsible for the work, which is not divided and carried on jointly by all the joint auditors. (2 Marks each, May, 2008)

Answer

(i) **False:** As per Section 139(6) of the Companies Act, 2013, First auditor of a newly formed company is to be appointed by the BOD within 30 days from the date of registration of the company. An auditor cannot be appointed as first auditor simply because his name has been stated in the articles of association.

(ii) This question is redundant in view of the provisions of the Companies Act, 2013.

(iii) **True:** As per SA 299 on "Responsibility of joint auditors" all the joint auditors are jointly and severally responsible for the audit work which is not divided and carried on jointly by all the joint auditors.

Question 30

When does an auditor issue unqualified opinion and what does it indicate? (4 Marks, May 2008)

Answer

Unqualified Opinion: The auditor should express an unqualified opinion when he concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for preparation and presentation of the financial statements.

An unqualified opinion indicates that:

(i) The financial statements have been prepared using the generally accepted accounting principles and being constantly followed.

(ii) The financial statements comply with relevant statutory requirements and regulations.

(iii) All material matters relevant to proper presentation of the financial information, subject to statutory requirement, if applicable, have been adequately disclosed.

Question 31

State with reasons (in short) whether the following statements are True or False:

(i) The first auditor appointed by the board of directors can be removed by the board at its subsequent meeting.

(ii) Internal auditor of the company cannot also be its cost auditor.

(iii) Where the accounts of the company do not present a "true and fair" view, the auditor should express disclaimer of opinion.

(iv) Government companies are also to be considered for the ceiling on number of audits.

(v) If appointment of a person as an auditor is void-ab-initio, it should be treated as a casual vacancy.

(vi) A company running a departmental store and having total turnover of ₹ 100 crores during the financial year 2006-07, need not get its branch audited whose turnover is ₹ 1.90 crores during the same year. *(2 Marks each, November, 2007)*

Answer

(i) False: According to Section 140 (1) the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014.

(ii) True: As per notification issued by the DCA, cost auditor should not be the internal auditor of a company for the period for which he is conducting the cost audit. It the cost auditor is also the internal auditor, he would not be able to discharge his duties properly.

(iii) False: An adverse opinion is appropriate where the reservations or the objections are so substantial that he feels that the accounts do not give a true and fair view. In this situation the auditor should give an adverse or negative opinion only.

(iv) True: As per section 141 (3)(g) Government companies will be considered for ceiling on number of audits.

(v) False: If appointment of a person as an auditor is void-ab-initio, it should not be treated as a casual vacancy, rather the existing auditor shall continue to be the auditor of the company u/s 139 (10) of the Companies Act, 2013.

(vi) False: As per section 143 (8) of the Companies Act, 2013, if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139. Therefore, branch audit is required.

Question 32

State the circumstances under which special audit may be called under Section 233 A of the Companies Act, 1956. *(3 Marks, November, 2007)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 33

State with reasons (in short) whether the following statements are True or False:

(i) Auditor's lien on his client's books and record is not unconditional.

(ii) An adverse report is one where an auditor gives an opinion subject to certain reservation.

(iii) CARO, 2004 does not applies to a Foreign company.

(iv) If the auditor appointed at the AGM refuses to accept the same, the Company can appoint another person by holding General Meeting. *(2 Marks each, May, 2007)*

Answer

(i) True: The auditor can exercise his lien on client's books and records subject to the following conditions:

(a) Document retained must belong to the client who owes the money.

(b) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.

(c) The auditor can retain the documents only if he has done work on the documents assigned to him.

(d) Such of the documents can be retained which are connected with the work on which fees have not been paid.

(ii) False: An adverse report is given when the auditor concludes that based on his examination he does not agree with the affirmation made in the financial statements.

(iii) This question is redundant in view of the provisions of the Companies Act, 2013.

(iv) False: This is not a casual vacancy. Since the newly appointed auditor has refused to accept the appointment, no appointment can be said to have been made at the AGM. Therefore, as per Section 139(10) of the Companies Act, 2013, the existing auditor shall continue to be the auditor of the company.

Question 34

State the basic elements of the Auditor's Report with illustration of Opening and opinion paragraphs. *(7 Marks, May, 2007)*

Answer

The question is redundant in view of change in Auditor's Report Format and Standard on Auditing.

Question 35

Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director. *(4 Marks, November, 2006)*

Answer

Appointment of First Auditor of Company: Section 139(6) of the Companies Act, 2013 (the Act) lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company". In the instant case, the appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 139(6) of the Act, which authorizes the Board of Directors to appoint the first auditor of the company within one month of registration of the company.

In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.

Question 36

PBS & Associates, a firm of Chartered Accountants, has three partners P, B and S. The firm is already having audit of 60 companies, which includes 2 branch audits of a company. The firm is offered 3 company audits, out of which one is a private company, other is a foreign company and the third one is a public company. Decide and advise whether PBS & Associates will exceed the ceiling prescribed under Section 224(1B) by accepting the above audit assignments? (4 Marks, November, 2006)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 37

Explain the scope paragraph of auditors Report. (8 Marks, November, 2006)

Answer

Scope Paragraph: As per "SA 700 Forming an Opinion and Reporting on Financial Statements", a description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

- A reference to Standards on Auditing and the law or regulation; and
- A description of an audit in accordance with those Standards;

Therefore, the auditor's report should prescribe the scope of the audit by stating that the audit was conducted in accordance with auditing standards generally accepted in India. The Engagement and Quality Control Standards issued by ICAI establish the auditing standards generally accepted in India. The reader needs this is as an assurance that the audit has been carried out in accordance with such established standards. Scope means auditor's ability to perform audit procedures deemed necessary in the circumstances.

Question 38

Why Central Government permission is required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term? (4 Marks, November, 2006)

Answer

Permission of Central Government for removal of auditor under section 140(1) of the Companies Act, 2013: Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence.

Further, in case of conflict of interest the shareholders may remove the auditors in their own interest.

Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand if auditor has completed his term i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

Question 39

As an auditor, comment on the following situation/statement:

X Ltd., to whom Companies (Auditor's Report) Order, 2003 is applicable, has issued 9% Debenture of ₹ 5 crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry Creditors and other Current Liabilities of ₹ 2.80 crores. *(5 Marks, May, 2006)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 40

Give your comments on the following:

(a) Mr. X, a Director of M/s KP Private Ltd., is also a Director of another company viz., M/s GP Private Ltd., which has not filed the annual accounts and annual return for last three years 2002-03 to 2004-05. Mr. X is of the opinion that he is not disqualified u/s 274(1)(g) of the Companies Act, 1956, and auditor should not mention disqualification remark in his audit report. *(5 Marks, May, 2006)*

(b) Mr. Aditya, a practising chartered accountant is appointed as a "Tax Consultant" of ABC Ltd., in which his father Mr. Singhvi is the Managing Director. *(4 Marks, May, 2006)*

(c) You have been appointed the sole auditor of a company where you were one of the joint auditors for the immediately preceding year and the said joint auditors is not re-appointed.

(4 Marks, May, 2006)

(d) No Annual General Meeting (AGM) was held for the year ended 31st March, 2005, in XYZ Ltd., Ninu is the auditor for the previous year, whether she is continuing to hold office for current year or not. *(3 Marks, May, 2006)*

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) **Appointment of a Practising CA as 'Tax Consultant':** A chartered accountant appointed as an auditor of a company, should ensure the independence in respect of his appointment as an auditor, else it would amount to "misconduct" under the Chartered Accountants Act, 1949 read with Guidance Note on Independence of Auditors.

In this case, Mr. Aditya is a “Tax Consultant” and not a “Statutory Auditor” or "Tax Auditor" of ABC Ltd., hence he is not subject to the above requirements.

(c) Appointment of Sole Auditor: When one of the joint auditors of the previous years is considered for ratification by the members as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. As per sub-section 4 of section 140 of the Companies Act, 2013, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed.

When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. Accordingly, provisions of the Companies Act, 2013 to be complied with are as under:

(i) Ascertain that special notice u/s 140(2) of the Companies Act, 2013 was received by the company from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice not earlier than three months but at least 14 days before the AGM date as per Section 115 of the Companies Act, 2013 read with rule 23(1) and 23(2) of the Companies (Management and Administration) Rules, 2014

(ii) Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Companies Act, 2013 read with rule 23(3) of the Companies (Management and Administration) Rules, 2014.

(iii) Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.

(iv) The notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Companies Act, 2013.

(v) Verify whether any representation, received from the retiring auditor was sent to the members of the company.

(vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(d) Tenure of Appointment: Section139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting. But in this regard it is to be noted that the company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.

In case the annual general meeting is not held within the period prescribed, the auditor will continue in office till the annual general meeting is actually held and concluded. Therefore, Ninu shall continue to hold office till the conclusion of the annual general meeting.

Question 41

Write short notes on "Statutory Report of a Public Company under section 165(4)".

(4 Marks, May, 2006)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 42

As an auditor, comment on the following:

Mr. A was appointed auditor of AAS Ltd. by Board to fill the casual vacancy that arose due to death of the auditor originally appointed in AGM. Subsequently, Mr. A also resigned on health grounds during the tenure of appointment. The Board filled this vacancy by appointing you through duly passed Board resolution. *(4 Marks, November, 2005)*

Answer

Filling of a Casual vacancy: Section 139(8) of the Companies Act, 2013 provides that any casual vacancy in the office of an auditor shall be filled by the Board of Directors within thirty days. However, if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

In the present case the auditor Mr. A resigned and the vacancy had been filled in by Board. But, the vacancy caused by resignation cannot be filled by Board itself, such appointment shall also be approved by the company at general meeting.

The fact that the Mr A was appointed by Board originally is a matter irrelevant in this situation. If the cause of vacancy is resignation, then the power of appointment shall vest with the general meeting only. As such, the appointment made by Board is invalid.

Question 43

Give your comments on the following:

The auditors of ABC Ltd. issued a qualified opinion about the truth and fairness of the accounts of the company for the year ended 31.3.2005. They typed out the matters of qualifications in a bold font so as to invite the attention of the readers to them. The Board objected to it and required them to be typed out in the same normal font as other paragraphs of the report appear. *(5 Marks, November, 2005)*

Answer

Qualified Report: It is duty of the auditor to state the reason for qualification or negative report as per sub section 4 of section 143 of the Companies Act, 2013. As per section 143 (4) where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for. It hardly matters that such qualifications are given in bold or normal font but it is important to provide the reason for.

Further, according to ICAI, this requirement does not in any way extent the scope of audit. It requires the auditor to evaluate his qualifications and make a judgement regarding which of them deal with matters that may have an adverse effect on the functioning of the company. Since auditor is of the view that such qualifications need to be highlighted in bold in conformity with the provisions of the set, the management has no right to object on the same.

Question 44

State the matters to be specified in Auditor's Report in terms of provisions of Section 227(3) of the Companies Act, 1956. *(8 Marks, November, 2005)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 45

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

(a) *A Ltd. has its Registered Office at New Delhi. During the current accounting year, it has shifted its Corporate Head Office to Indore though it has retained the Registered Office at New Delhi. The Managing Director of the Company wants to shift its books of account to Indore from New Delhi, as he feels that there is no legal bar in doing so.*

(4 Marks, May, 2005)

(b) *The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts were considered.* *(5 Marks, May, 2005)*

(c) *The auditor of a company wanted to see the minutes book of Directors meetings. The Chairman of the company refused for the same on the ground that matters of confidential nature were contained therein.* *(5 Marks, May, 2005)*

Answer

(a) Shifting of Books of Account: As per section 128(1) of The Companies Act 2013, every company shall keep at its registered office proper books of accounts. It is permissible, however, for all or any of the books of accounts to be kept at such place in India as the Board of Directors may decide but, when a decision in this regard is taken, the company must file within seven days of such decision with the Registrar of Companies a notice in writing giving full address of the other place.

Conclusion: In view of the above provisions, A Ltd should maintain its books of account at its registered office at New Delhi. The Managing Director is not allowed to shift its books of account to Indore unless decision in this behalf is taken by the Board of Directors and a notice is also given to the Registrar of Companies within the specified time. The auditor may accordingly, inform the Managing Director that his contention is not in accordance with the legal provisions.

(b) Auditor's Attendance at Annual General Meeting: Section 143 of the Companies Act, 2013 confers right on the auditor to attend the general meeting.

The said section provides that all notices and other communications relating to any general meeting of a company also to be forwarded to the auditor. Further, it has been provided that the auditor shall be, unless otherwise exempted, entitled to attend any general meeting and to be heard at such general meeting which he attends on any part of the business which concerns him as an auditor.

Therefore, the section does not cast any duty on the auditor to attend the annual general meeting. The law only confers right on the auditor to receive notices and also attend the meeting if he so desires. Therefore, the complaint filed by the Board of Directors is based on mis-conception of the law.

(c) Right of Access to Board's Minutes: Under Section 143(1) of the Companies Act, 2013, the auditor of a company has the right of access at all times to books of account and vouchers of the company, whether kept at the registered office of the company or elsewhere.

Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the directors' minute book.

The refusal by Chairman to provide access to Directors' Minutes Book shall constitute limitation of scope as far as the auditor's duties are concerned. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

Question 46

Give your comment on "The Central Government has appointed Mr. Sushil, a retired Finance Director of a reputed company, a non-practising member of ICAI, as a special auditor of MM Ltd., on the ground that the company was not being managed on sound business principles. Mr. Ajay, MD of MM Ltd. feels, that the appointment of Mr. Sushil is not valid as he does not hold a certificate of practice". (5 Marks, May, 2005)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 47

What categories of Companies are specifically exempted from the application of Companies (Auditor's Report) Order, 2003? (8 Marks, May, 2005)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 48

Explain the term "Auditor's Lien". (8 Marks, May, 2005)

Answer

Auditor's Lien: In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property.

On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents.

The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

(i) Documents retained must belong to the client who owes the money.

(ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.

(iii) The auditor can retain the documents only if he has done work on the documents assigned to him.

(iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under section 128 of the Companies Act, 2013, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

Further, as per SA 230 "Audit Documentation", "working papers are the property of the auditor". The auditor may at his discretion make portions of or extracts from his working papers available to his clients.

Thus, documents prepared by the professional accountant solely for the purpose of carrying out his duties as auditor (whether under statutory provisions or otherwise) belong to the professional accountant.

In the case of *Chantrey Martin and Co. v. Martin*, it was held that the following documents were the property of the auditor: working papers and schedules relating to the audit, draft accounts of the company, and the draft tax computation prepared by an employee of the auditor.

It is also clear that the accountant's correspondence with his client (letters written by the client to the accountant and copies of the letters written by the accountant to the client) belong to the accountant. In the case of *Chantrey Martin and Co. v. Martin*, it was also held that the correspondence between the accountant and the taxation authorities with regard to the client's accounts and tax computations was the property of the client since the accountant merely acted as agent of the client.

However, where the accountant communicates with third parties not as an agent, but as a professional man, e.g., as an auditor, the correspondence with third parties would seem to belong to the accountant. According to the statement, where an auditor obtains documents confirming the bank balance or confirming the custody of securities of the client or other similar documents, it is probable that the courts would hold that these documents belong to the auditor.

Question 49

Write a short note on "Cost Audit". *(4 Marks, May, 2005)*

Answer

Cost Audit: Cost Audit is covered by Section 148 of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143 of the Companies Act, 2013.

As per the section 148 the Central Government may by order specify audit of items of cost in respect of certain companies.

The audit shall be conducted by a Cost Accountant in Practice who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter X of the Companies Act, 2013 shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

The report on the audit of cost records shall be submitted to the Board of Directors of the company and company shall within thirty days from the date of receipt of a copy of the cost audit report prepared furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.

Question 50

(a) *E and S were appointed as Joint Auditors of X and Y Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the notice of both the Auditors.* *(5 Marks, November, 2004)*

(b) *Aakansha is a member of the Institute of Chartered Accountants of England and Wales. Is she qualified to be appointed as auditor of Indian Companies?*

(2 Marks, November, 2004)

(c) *Preksha, a member of the ICAI, does not hold a Certificate of practice. Is her appointment as an auditor valid?* *(4 Marks, November, 2004)*

(d) *'B' owes ₹1001 to 'C' Ltd., of which he is an auditor. Is his appointment valid? Will it make any difference, if the advance is taken for meeting-out travelling expenses?*

(4 Marks, November, 2004)

Answer

(a) Responsibilities of Joint Auditors: In conducting a joint audit, the auditor(s) should bear in mind the possibility of existence of any fraud or error or any other irregularities in the accounts under audit. The principles laid down in SA 200, SA 240 and SA 299 need to be read together for arriving at any conclusion. The principle of joint audit involves that each auditor is entitled to assume that other joint auditor has carried out his part of work properly. However, in this case, if it can be assumed that the joint auditors E and S have exercised reasonable care and skill in auditing the accounts of X & Y Ltd. and yet the concealment of transaction has taken place, both joint auditors cannot be held responsible for professional negligence. However, if such concealment could have been discovered by the exercise of reasonable care and skill, the auditors would be responsible for professional negligence. Therefore, it has to be seen that while dividing the work, the joint auditors have not left any area unattended and exercised reasonable care and skill while doing their work.

(b) Qualification for Appointment as an Auditor: Aakansha, a member of the Institute of Chartered Accountants in England and Wales is not qualified to be appointed as an auditor of a limited company in India, since she is not a chartered accountant within the meaning of the Chartered Accountants Act, 1949 and hence not a member of the Institute of Chartered Accountants of India. Because as per the Chartered Accountants Act, 1949, a person must be a member of the Institute and holds certificate of practice. However, as it appears from the facts given in the case, Aakansha is not a member of the Institute of Chartered Accountants of India and, thus, is not qualified to audit companies under the Companies Act, 1956.

(c) **Qualifications of an Auditor:** A person shall be qualified for appointment as an auditor of a company, only if one is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Under the Chartered Accountants Act, 1949, only a chartered accountant holding the certificate of practice can engage in public practice.

In the instant case**,** Preksha does not hold a certificate of practice hence she cannot be appointed as an auditor of a company.

(d) **Indebtedness to the Company:** As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding ₹ 5,00,000 then he is not qualified for appointment as an auditor of a company. Accordingly, B's appointment is valid and he is not disqualified as the amount of debt does not exceeds ₹ 5,00,000. No, it will not make any difference, if the advance is taken for meeting-out travelling expenses as the amount is within the prescribed limit.

Question 51

Explain the various types of companies under Companies (Auditor's Report) Order, 2003 (CARO). (8 Marks, November, 2004)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 52

Write short notes on "Audit enquiry under Section 227(1A)". (4 Marks, November, 2004)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 53

Give your comments on the following:

(a) PQR & Co. a firm of Chartered Accountants has three partners, P, Q and R; P is also in whole time employment elsewhere. The firm is already holding audit of 40 companies including audit of one foreign company. The firm is offered the audit of Z Ltd. and its 20 branches. (5 Marks, May, 2004)

(b) Nene and Sane Associates, Chartered Accountants in practice have been appointed as statutory auditor of Do Good Ltd. for the accounting year 2003-04. Mr. Nene holds 200 equity shares of DDA Ltd. a subsidiary company of Do Good Ltd. (5 Marks, May, 2004)

(c) White Star Ltd. was incorporated on 1.8.2003 and Mr. T who is related to the Chairman of the Company appointed as auditor by the Board of Directors in their meeting on 4.9.2003.

(4 Marks, May, 2004)

Answer

(a) Number of Company Audits: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

As per section 141 (3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

In the firm of M/s PQR & Co., P is in whole-time employment elsewhere. Hence he will be excluded in determining the number of company audits that the firm can hold. If Q and R do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by PQR & Co. is 20 x 2 = 40 which is as per prescribed limit. Therefore, M/s PQR & Co. can not accept audit of Z Ltd. and its 20 branches as per section 141(3) (g) of the Companies Act, 2013.

(b) Auditor holding securities of a company: As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Provided that the relative may hold security or interest in the company of face value not exceeding rupees one lakh.

Also, as per sub-section 4 of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Nene, Chartered Accountant, a partner of M/s Nene and Sane Associates, holds 200 equity shares of DDA Ltd. which is a subsidiary of Do Good Ltd. Therefore, the firm, M/s Nene and Sane Associates would be disqualified to be appointed as statutory auditor of Do Good Ltd., which is the holding company of DDA Ltd., because one of the partner Mr. Nene is holding equity shares of its subsidiary.

(c) **Appointment of First Auditors by the Board:** Apparently, there are two issues arising out of this situation, viz., first one relates to appointment of first auditor by the Board of Directors; and second, pertains to relation of such an auditor with the Chairman of the company. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditors, it may be noted as per the provisions of Section 139(6) of the Companies Act, 2013, the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company. As per the facts given in the case, the Board has failed to appoint the first auditor within 30 days from the registration of company because the date of incorporation of White Star Ltd. is 1-8-2013 and the date of appointment of auditors by the Board of Directors is 4-9-2013. Accordingly if the Board fails to appoint the first auditor, it shall inform the members of the company, who shall within 90 days at an extraordinary general meeting has to make the appointment. Thus the appointment of Mr. T is not valid. Under the circumstances, the second issue relating to relationship of auditor with the Chairman becomes redundant.

Question 54

Draft an illustrative Audit Report u/s 227 of the Companies Act, 1956, with a few qualifications. Annexure u/s 227(4A) is not required. *(16 Marks, May, 2004)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

8

The Company Audit- II

Question 1

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, November, 2013)

Or

How would you vouch/verify Re-issue of Forfeited Shares. (4 Marks, November, 2006)

Answer

Re-issue of forfeited shares:

(i) The auditor should ascertain that the board of directors has the authority under the Articles of Association of the company to reissue forfeited shares. Check the relevant resolution of the Board of Directors.

(ii) Vouch the amounts collected from persons to whom the shares have been allotted and verify the entries recorded from re-allotment. Auditor should check the total amount received on the shares including received prior to forfeiture, is not less than the par value of shares.

(iii) Verify that computation of surplus amount arising on the reissue of shares credited to Capital Reserve Account.

(iv) Where partly paid shares are forfeited for non-payment of call, and re-issued as fully paid, the reissue is considered as an allotment at a discount and compliance of the provisions of Section 53 of the Companies Act, 2013 is essential as issuance of shares at discount other than sweat equity share are void.

Question 2

Anandbhai & Co. Ltd. issued shares to the equity shareholders in the proportion of one bonus share for every three existing shares. As an auditor of the Company how would you verify this issue? (4 Marks, May, 2013)

Answer

Verification of Issue of Bonus Shares: A company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of (i) its free reserves; (ii) the securities premium account; or (iii) the capital redemption reserve account.

The auditor should ensure that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Further, he should also ensure the compliance of condition for capitalization of profits or reserves for the issuing fully paid-up bonus shares like -

(i) it is authorised by its articles;

(ii) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(iii) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(iv) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(v) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(vi) it complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same;

(vii) the bonus shares shall not be issued in lieu of dividend.

Question 3

Discuss on the following:

(a) Shares issued at a discount. (5 Marks, November, 2012)

(b) Payment of interest to the shareholders on capital raised by issue of shares to meet the cost of construction of building which cannot be made profitable for a long period.

(5 Marks, May, 2012)

Answer

(a) Issue of Shares at a Discount: According to Section 53 of the Companies Act, 2013, except sweat equity issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 4

As an auditor, how will you verify application and allotment money received on shares issued for cash? (8 Marks, November, 2012)

Answer

Verification of application and allotment money received on Shares Issued for Cash shall be carried out as under:

On Application: Verify the amount received along with the applications for shares in the following manner:

(i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;

(ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;

(iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;

(iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

On Allotment:

(i) Examine Director's Minutes Book to verify approval of allotments.

(ii) Compare copies of letters of allotment with entries in the Application and Allotment Book.

(iii) Trace entries in the Cash book into the Application and Allotment Book for the verification of amounts collected on allotment.

(iv) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share Register.

(v) Check whether the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on such application have been received by the company.

(vi) Check that the amount payable on the application on every security is not less than five percent of the nominal amount of security or such other percentage or amount as may be prescribed by the SEBI.

(vii) If the stated minimum amount has not been subscribed and the sum payable on subscription is not received within a period of thirty days from the date of issue of the prospectus or such period as my be specified by the SEBI, check that the amount received above is returned within a period of fifteen days from the closure of the issue and if in case the amount is not repaid within such period, the directors in default shall jointly and severally be liable to repay that amount with interest at the rate of fifteen percent per annum.

(v) Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.

Question 5

Discuss the audit procedure for verification of payment of dividends. *(8 Marks, May, 2012)*

Answer

Verification of Dividends: The procedure for the verification of payment of dividends is stated below:

(i) Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.

(ii) Confirm that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Section 123 of the Companies Act, 2013. If the company proposes to pay the dividend out of past profit in reserves, see that either this is in accordance with the rules framed by the Central Government in this behalf or the consent of the Government has been obtained.

(iii) Inspect the Shareholders' Minute Book to verify the amount of dividend declared and confirm that the amount recommended by the directors.

(iv) If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.

(v) Check the particulars of members as are entered in the Dividend Register or Dividend List by reference to the Register of Members, test check the calculation of the gross amount of dividend payable to each shareholder on the basis of the number of the shares held and the amount of CDT, if applicable. Verify the casts and crosscast of the different columns.

(vi) Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in the Dividend Bank Account.

(vii) Examine the dividend warrants in respect of previous years, presented during the year for payment and verify that by their payment, any provision contained in the Articles in the matter of period of time during which amount of unclaimed dividend can be paid had not been contravened.

(viii) According to section 123, as it is compulsory for a company to transfer the total amount of dividend which remains unpaid or unclaimed, within thirty days of the declaration of the dividend to a special bank account entitled "Unpaid Dividend Account of .... Company Limited/Company (Pvt.) Limited". Such an account is to be opened only in a scheduled bank. The transfer must be made within 7 days from the date of expiry of thirty days.

The expression "dividend which remains unpaid" means any dividend the warrant in respect thereof has not been encashed or which has otherwise not been paid or claimed.

(ix) In case any money transferred to the unpaid dividend amount of a company remain unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred to Investor Education and Protection Fund established under section 125 of the Companies Act, 2013.

(x) Ensure the compliance, in case dividend is paid in case of inadequate profits.

Question 6

How an auditor can audit allotment of debentures? *(8 Marks, November, 2011)*

Answer

Allotment of Debentures: Following are the steps to be taken by an auditor while doing the audit of allotment of debentures:

(i) Verify that the Prospectus or the Statement in lieu of Prospectus had been duly filed with the Registrar before the date of allotment.

(ii) Check the applications for debentures with the Application and Allotment Book to verify that the name, address of the applicants and the number of debentures applied for are correctly recorded.

(iii) Verify the allotment of debentures by reference to the Directors' Minute Book.

(iv) Vouch the amounts collected as are entered in the Cash Book with the counterfoils of receipts issued to the applicants; also trace the amounts into the Application and Allotment Book.

(v) Check postings of allotments of debentures and the amounts received in respect thereof from the Application and Allotment Book, into the Debentures Register.

(vi) Verify the entries on the counterfoils of debentures issued with the Debentures Register.

(vii) Extract balances in the Debentures Register in respect of amounts paid by the debenture holders and agree their total with the balance in the Debentures Account in the General Ledger.

(viii) Examine a copy of the Debenture Trust Deed and note the conditions including creation of Debenture Redemption Reserve contained therein as to issue and repayment.

(ix) If the debentures are covered by a mortgage or charge, it should be verified that the charge has been correctly recorded in the Register of Mortgages and Charges and that it has also been registered with the Registrar of Companies. Further, that the charge is clearly disclosed in the Balance Sheet.

(x) Compliance with SEBI Guidelines and section 71 of the Companies Act, 2013, should also be seen.

(xi) Where debentures have been issued as fully paid up to vendors as a part of the purchase consideration, the contract in this regard should be referred to.

Question 7

What are the duties of an auditor in case of reduction of capital? (8 Marks, November, 2011)

Or

How would you vouch/verify Reduction in Share Capital. (5 Marks, May, 2010)

Answer

Reduction of Capital:

(i) Verifying that the meeting of the shareholder held to pass the special resolution was properly convened; also that the proposal was circularised in advance among the members.

(ii) Confirming that the Articles of Association authorise reduction of capital.

(iii) Examining the order of the Tribunal confirming the reduction and seeing that a copy of the order and the minutes have been registered and filed with the Registrar of Companies.

(iv) Inspecting the Registrar's Certificate as regards reduction of capital.

(v) Vouching the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also seeing that the requirements of Schedule III, Part I, have been complied with.

(vi) Confirming that the revaluation of assets have been properly disclosed in the Balance Sheet.

(vii) Verifying the adjustment made in the members' accounts in the Register of Members and confirming that either the paid up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled.

(viii) Confirming that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.

(ix) Verifying that the Memorandum of Association of the company has been suitably altered.

[Note: Reduction of Capital is discussed in section 100 of the Companies Act, 1956, which is replaced by the section 66 of the Companies Act, 2013. This section is not yet notified.]

Question 8

Explain the powers of company to purchase its own securities. *(8 Marks, May, 2011)*

Or

Discuss in brief the power of Company purchase its own Securities. *(5 Marks, November, 2008)*

Answer

Power of Company to buy back its Own Securities: The Companies Act, 2013 under Section 68 (1) permits companies to buyback their own shares and other specified securities out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of the issue of any shares or other specified securities.

Note: No buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

The other important provisions relating to the buyback are:

(i) Section 68 (2) further states that no company shall purchase its own shares or other specified securities unless—

(a) the buy-back is authorised by its articles;

(b) a special resolution has been passed in general meeting of the company authorising the buy-back;

However, the above provisions do not apply where the buy back is ten percent or less of the paid up equity capital + free reserves AND is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy back is upto 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of its being authorized by the articles of association of the company and by a special resolution of its members passed at a general meeting of the company.

(c) the buy-back is equal or less than twenty-five per cent of the total paid-up capital and free reserves of the company:

Note: the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital + free reserves in that financial year.

(d) the ratio of the debt owed by the company (both secured and unsecured) after such buy - back is not more than twice the total of its paid up capital and its free reserves:

Note: Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies.

(e) all the shares or other specified securities for buy-back are fully paid-up;

(f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

(g) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

Provided that no offer of buy back under this sub section shall be made within a period of one year reckoned from the date of closure of a previous offer of buy back if any. This means that there cannot be more than one buy back in one year.

(ii) Every buy-back shall be completed within twelve months from the date of passing the special resolution, or the resolution passed by the board of directors where the buy back is upto 10% of the paid up equity capital + free reserves.

(iii) The buy-back may be—

(a) from the existing security holders on a proportionate basis; or

(b) from the open market; or

(c) from odd lots, that is to say, where the lot of securities of a public company, whose shares are listed on a recognised stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange; or

(d) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(iv) Where a company has passed a special resolution under clause (b) of Sub-section (2) to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any :

Note: No declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

(v) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.

(vi) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of further shares under clause (a) of Sub-section (1) of Section (62) or other specified securities within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.

(vii) If a company makes default in complying with the provisions of this section or any regulations made by SEBI in this regard, the company may be punishable with a fine which shall not be less than Rupees One Lakh but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for upto 3 years or with a fine of not less than one lakh rupees but which may extend to three lakh rupees or with both.

(viii) Section 69 (1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.

(ix) The Capital Redemption Reserve Account may be applied by the company in the issue of bonus shares to the members of the company.

(x) Where a company buy-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

(xi) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed, provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

Schedule III to the Companies Act, 2013 Requirements:

Under the head "Share Capital", a company is required to disclose for the period of five years immediately preceding the date as at which the Balance Sheet is prepared, the aggregate number and class of shares bought back.

Question 9

Write short note on "Reissue of redeemed debentures". (4 Marks, May, 2011)

Answer

This question is redundant in view of provisions of the Companies Act, 2013.

Question 10

State with reasons (in short) whether the following statement is True or False:

A special resolution is required by company to authorize issue of shares at discount.

(2 Marks, May, 2010)

Answer

False: According to Section 53 of the Companies Act, 2013, except sweat equity issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Question 11

How would you vouch/verify Receipt of Capital subsidy. (5 Marks, May, 2010)

Answer

Receipt of Capital Subsidy

(i) Refer to office copy of application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to use of subsidy.

(iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up an industrial unit at a specified area/location.

(iv) Check the relevant entries in the books for receipt of subsidy.

(v) Ensure that compliance requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for and also compliance with the disclosure requirements.

Question 12

State with reasons (in short) whether the following statement is True or False:

Interim dividend is not a part of dividend. (2 Marks, November, 2009)

Answer

False: As per the Companies Act, 2013 the definition of "dividend" includes the interim dividend. Thus interim dividend is a part of dividend.

Question 13

(a) State clearly provisions of the Companies Act, 1956 with regard to issue of shares at a discount.

(b) As an auditor, comment on the following situation:

MNR Co. Ltd. did not provide for depreciation during the financial year 2007-08 due to inadequacy of profits. The company declared dividend during the financial year 2008-09 without providing for the previous year's depreciation. (5 Marks each, November, 2009)

Answer

(a) Issue of Shares at a Discount: According to Section 53 of the Companies Act, 2013, except sweat equity issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

(b) Payment of dividend without providing for arrears of depreciation: Section 123 (1) of the Companies Act, 2013 read with Rule 5 of Companies (Declaration and Payment of Dividend) Rules, 2014, prescribes that if a company has not made provision for depreciation for any previous financial year, it should provide for such depreciation before declaring/paying dividend:

(i) Either out of the profits of that financial year or

(ii) Out of the profits of any other previous years.

In the present case, it would be necessary to make provisions for depreciation in respect of 2007-08 and 2008-09 in the first instance and the balance of profit after providing depreciation including the previous year, could be used for distribution as dividend. Since the company has contravened the provisions of the Companies Act, 2013, the auditor should qualify his audit report.

Question 14

State with reasons (in short) whether the following statements are True or False:

(i) Capital profits realized in cash may be distributed as divided, provided the articles do not prohibit, hence profit on reissue of Forfeited shares may be distributed as Dividend.

(ii) "Auditor is not an Insurer". (2 Marks each, November, 2008)

Answer

(i) False: As per proviso to section 123(1) of the Companies Act, 2013, no dividend shall be declared or paid by a company from its reserves other than free reserves.

(ii) True: While examining the evidences relating to business organization or the state of the affairs of the company, the auditor's duty is limited only to the verification of the evidence that is made available to him in ordinary course of audit or that which he would call upon to examine on a doubt having arisen that there is something wrong. Hence auditor is not an insurer.

Question 15

Write short note on "Payment of Interest out of Capital during construction".

(5 Marks, November, 2008)

Answer

This question is redundant in view of provisions of the Companies Act, 2013.

Question 16

Briefly mention five important items which you would examine while verifying payment of interest out of capital during construction. *(5 Marks, May, 2008)*

Answer

This question is redundant in view of provisions of the Companies Act, 2013.

Question 17

State with reasons (in short) whether the following statement is True or False:

"Surplus on the re-issue of forfeited shares standing to the credit of share forfeited account can be distributed as dividend". *(2 Marks, November, 2007)*

Answer

False: As per proviso to section 123(1) of the Companies Act, 2013, no dividend shall be declared or paid by a company from its reserves other than free reserves. Therefore, surplus on the re-issue of forfeited shares standing to the credit of share forfeited account cannot be distributed as dividend.

Question 18

Explain the Director's responsibility statement. *(6 Marks, November, 2007)*

Answer

Director's Responsibility Statement: The report of board of directors on annual accounts shall also include a 'Director's Responsibility statement' indicating therein: The directors' responsibility statement referred to in section 134(3) (c) of the Companies Act, 2013 shall state that—

(i) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(ii) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

(iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) the directors had prepared the annual accounts on a going concern basis;

(v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Here, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and

(vi) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

Question 19

As an auditor, comment on the following situation/statement:

The register of members of AP Ltd. has not been written up-to-date and as a result, the balances in the register do not agree with the amount of issued Share Capital.

(5 Marks, May, 2006)

Answer

Maintenance of Statutory Register: Register of members is a statutory book, which should be maintained by every company. The auditor should ascertain whether the company updates the register and then examine whether it is in agreement with the amount of issued capital. Because in the audit of share capital, it constitutes one of the internal documentary evidence. The auditor may also consider applying alternative audit procedures because If the company fails to update the register and the auditor fails to obtain sufficient appropriate audit evidence, the auditor may qualify his report.

Question 20

What are the reporting requirements in Companies (Auditor's Report) Order, 2003 in respect of money raised by public issues? *(8 Marks, November, 2005)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 21

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

Z Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31st March, 2004:

	Amount ₹ in lacs
Securities Premium Account	80
Capital Reserve	60
General Reserve	90

The company had an accumulated loss of ₹ 40 lacs on the same date, which it has disclosed under the head "Profit and Loss Account" on the assets side of the Balance Sheet.

(4 Marks, May, 2005)

Answer

Debit Balance of Profit and Loss Account: Part I of Schedule III to the Companies Act, 2013 requires that the debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Hence, the accumulated loss of ₹ 40 lakhs should be presented as negative figure in Part I of Schedule III. In the present case, the disclosure requirements of Schedule III to the Companies Act, 2013 have not been followed and, accordingly, the auditor should modify his report.

Requirements of Schedule III to the Companies Act, 2013:
As per Schedule III to the Companies Act, 2013, Share Capital has to be presented in the following manner: *I. Equity and Liabilities:* *1. Shareholders' Funds:* *(a) Share Capital* *(b) Reserves and Surplus* *(c) Money Received under Share Warrants*
General Instructions for Reserve and Surplus under Schedule III to the Companies Act, 2013
(i) Reserves and Surplus shall be classified as: *(a) Capital Reserves;* *(b) Capital Redemption Reserve;* *(c) Securities Premium Reserve;* *(d) Debenture Redemption Reserve;*

> *(e) Revaluation Reserve;*
>
> *(f) Share Options Outstanding Account;*
>
> *(g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);*
>
> *(h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.*
>
> *(Additions and deductions since last balance sheet to be shown under each of the specified heads)*
>
> *(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.*
>
> *(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.*

Question 22

Write a short note on "Capital Redemption Reserve". (4 Marks, May, 2005)

Answer

Capital Redemption Reserve: As per Section 55 of the Companies Act, 2013 where preference shares are proposed to be redeemed out of the profits of the company, there shall, out of such profits, be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve, to be called the Capital Redemption Reserve Account, and the provisions of the Companies Act, 2013 relating to reduction of share capital of a company shall, except as provided in this section, apply as if the Capital Redemption Reserve Account were paid-up share capital of the company; and the capital redemption reserve account may, notwithstanding anything in this section, be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Capital Redemption Reserve should be disclosed under the head "Reserves & Surplus" on the Liabilities side of the Balance Sheet as per Part-I of Schedule III to the Companies Act, 2013.

Question 23

As an auditor, comment on the following situation/statement:

X Ltd. is good in profits, but suffers temporarily in liquidity. It proposes to declare dividend of 10% in annual general meeting, but the Board proposes to defer payment of dividend by two months from the date of annual general meeting by getting a resolution passed in AGM.

(4 Marks, November, 2004)

Answer

Declaration of Dividends: As per law, dividend once declared cannot be revoked. However, as per facts of the case, X Ltd. has not declared the dividends so far because Board proposed to recommend declaration of 10% dividend in annual general meeting but in view of liquidity problem it proposes to defer the payment of dividend by two months from the date of annual general meeting by getting a resolution passed in AGM. As per the question it is clear that the Board has only made a proposal and the same has not been passed by the shareholders. Therefore, in such a case, X Ltd. may declare dividends at a subsequent general meeting.

Question 24

As an auditor, comment on the following situation statement:

Ganga-Kaveri Project Ltd. was incorporated on 1.7.2002. During the year ended 31.3.2003 there was no manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds. Therefore the Chief Accountant of the company contends that for the relevant year there was no need to prepare a statement of profit or loss or any other statement except a Balance Sheet as at 31.3.2003.

(5 Marks, May, 2004)

Answer

Preparation of Financial Statements: Section 128 of the Companies Act, 2013 requires every company to prepare its financial statements for every financial year which gives a true and fair view of the state of the affairs of the company and such books shall be kept on accrual basis, and according to the double entry system of accounting. Further, the definition of "financial statement", given under section 2(40) of the Companies Act, 2013, includes a profit and loss account also.

In the given case, Ganga-Kaveri Project Ltd. did not carry any manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery, etc.

Though the company did not carry any manufacturing or trading activity, the company has carried on certain activities like construction of factory shed, acquisition of plant and machinery etc. In such a case, it is necessary to provide for depreciation and other expenses.

The mere fact that there was no manufacturing or trading activity cannot be the basis for not preparing the Statement of Profit and Loss. Therefore, the contention of the Chief Accountant is not correct.

9

Special Audits

Question 1

(a) *What procedure may be adopted by an auditor, while auditing leasing transactions entered into by the leasing company?*

(b) *Mention any eight important points which an auditor will consider while conducting audit of club?* *(8 Marks each, November, 2013)*

Or

Mention briefly important points which an auditor will consider while conducting the audit of a club. *(8 Marks, November, 2010)*

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, 2013 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 inventory 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 inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.

(x) Check the inventory of furniture, sports material and other assets physically with the respective inventory 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 2

Write short notes on "Basic standards set for audit of Government expenditure".

(4 Marks, November, 2013)

Answer

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*.

Question 3

(a) Mention important points which auditors will consider while conducting audit of accounts of a partnership firm. *(8 Marks, May, 2013)*

(b) What are the points on which an auditor should concentrate while planning audit of an N.G.O.? *(8 Marks, May, 2013)*

Answer

(a) Audit of a Partnership Firm: Important points which auditors will consider while conducting audit of accounts of a partnership firm are:

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

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

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

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

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

(vi) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

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

(b) Audit of a N.G.O.: While planning the audit of a N.G.O., the auditor should concentrate on the following:

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.

(ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.

(iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(iv) Reviewing the NGO's Organisation chart, Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(v) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(vii) Setting of materiality levels for audit purposes.

(viii) The nature and timing of reports or other communications.

(ix) The involvement of experts and their reports.

(x) Review the previous year's Audit Report.

Question 4

What are the duties of Comptroller and Auditor General? *(10 Marks, November, 2012)*

Answer

Duties of Comptroller & Auditor General: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under:

(i) **Compile and submit Accounts of Union and States -** The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) **General Provisions Relating to Audit -** It shall be the duty of the C&AG –

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) **Audit of Receipts and Expenditure -** Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) **Audit of Grants or Loans -** Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) **Audit of Receipts of Union or States -** It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) **Audit of Accounts of Stores and Inventory -** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) **Audit of Government Companies and Corporations -** The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Question 5

What are the eight audit points to be considered by the auditor during the audit of a Hospital?

(8 Marks, November, 2012)

Or

Mention any 8 special points which you as an auditor would look into while auditing the books of accounts of Hospital. *(8 Marks, May, 2011)*

Answer

Audit of Hospital: The audit points to be considered by the auditor during the audit of a Hospital are stated below:-

(i) Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(iii) See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.

(iv) Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(vi) Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(vii) Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(viii) Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.

(ix) Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

(x) See that depreciation has been written off against all the assets at the appropriate rates.

(xi) Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) Obtain inventories, especially of inventories and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

Question 6

Mention the eight important points which an auditor will consider while conducting the audit of educational institutions. *(8 Marks, May, 2012)*

Or

What are the special steps involved in conducting the audit of an Educational Institution?

(16 Marks, November, 2004)

Answer

Audit of Educational Institutions: The important points which an auditor should consider while conducting the audit of education institutions are as follows:

(i) Examine the Trust Deed or Regulations, in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prescribed by the Managing Committee.

(viii) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant paper of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the amount budget was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Finally, verify the annual statements of account and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

Question 7

(a) Mention 8 special points which you as an auditor would look into while auditing the accounts of a Recreation Club with facilities for indoor games and in house eatery.

(b) What are the focus points in doing propriety audits by C & AG as regards government expenditure? (8 Marks each, November, 2011)

Answer

(a) Audit of Accounts of Recreational Club

(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, 2013 should also be seen.

(ii) Vouch the receipt on account of entrance fees with member's 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 mentioned in the Audit Report.

(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 inventory 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 inventory of unsold provisions and stores, at the end of the year should be verified physically and its valuation checked.

(vii) Check the inventory of furniture, sports material and other assets physically with the respective inventory 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 there from and provision of income tax thereon. .

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

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

(i) The expenditure should not be prima facie more than what the occasion demands. Public money should be spent by the officers, as of their own with utmost diligence and care.

(ii) No order for sanction of expenditure should be made by an authority which results in pecuniary gains directly or indirectly.

(iii) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

   (1) the amount of expenditure involved is insignificant; or

   (2) a claim for the amount could be enforced in a Court of law; or

   (3) the expenditure is in pursuance of a recognised policy or custom; and

   (4) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

(iv) There should not be profiteering by the authority or anybody where the expenditure is in the nature of compensating.

(v) Wastages are avoided in expenditure.

(vi) The cost of administering should not eat off the benefits of the expenditure.

(vii) The expenditure should percolate down the beneficiary without corruption.

(viii) The expenditure should bring out optimum, enduring benefits instead of mere frittering away the public money on meeting day to day needs repeatedly.

Question 8

Mention any 8 special points which you as an auditor would look into while auditing the books of accounts of Cinema. *(8 Marks, May, 2011)*

Answer

Audit of Cinema: The special steps involved in its audit are as follows:-

(i) Verify

   (1) that entrance to the cinema hall during show is only through printed tickets;

   (2) that they are serially numbered and bound into books;

   (3) that the number of tickets issued for each show and class, are different with the numbers of the same class for the show on the same day, each week, sum serially;

   (4) that for advance booking a separate series of tickets is issued; and

   (5) that the inventory of tickets is kept in the custody of a responsible official.

(ii) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(iii) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(iv) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.

(v) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different show on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(vi) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.

(vii) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalised except the expenditure on extensive redecoration, and that should be adjusted as deferred revenue expenditure.

(viii) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate which is higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

(ix) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(x) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquire as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

(xi) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, cigarettes, etc. as in the case of club.

Question 9

Write short note on "Audit of expenditure in Government audit". (4 Marks, May, 2011)

Answer

Audit of Expenditure in Government Audit: The various standards set for audit of expenditure are:

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

(ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.

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

(iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

(v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Question 10

What important points should an auditor keep in mind while checking receipt of income of a Non-Governmental Organization (N.G.O.)? *(4 Marks, November, 2010)*

Or

Mention the important items to be examined by the auditor in the receipt of Income of Non-Governmental Organisations (NGO's). *(10 Marks, May, 2004)*

Answer

Income of Non-Governmental Organisations (NGOs): Non-Governmental organisations are non-profit making organisations which raise funds from members, donors or contributors for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, etc. The receipt of income of NGOs requiring examination by the auditor are as under:

(i) **Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) **Subscriptions**: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.

(v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

Question 11

Draft an audit programme for conducting audit of accounts of a Local Body. (5 Marks, May, 2010)

Answer

Audit of local bodies

(i) The Local Fund Audit Wing of the State Government is generally in charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure authenticity of his appointment.

(ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; upon whether value is being fully received on money spent. His objective should be, to detect errors and fraud and misuse of resources.

(iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

(iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.

(vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Question 12

What are the six important points that will attract your attention in the case of audit of a Hotel?

(5 Marks, November, 2009)

Or

What special steps will you take into consideration in auditing the accounts of a hotel?

(10 Marks, May, 2005)

Answer

Audit of a Hotel: The business of running a hotel is very much dissimilar to running an industrial unit for manufacturing of products. It is a service-oriented industry. The business is characterized by handling of large amounts of liquid cash, inventory of foods providing a variety of services, and keeping watch on customers to ensure that they do not leave hotel without settling the dues. In view of these, the following matters require special attention by the auditor:

(i) **Internal Control:** Pilferage is one of the greatest problems in any hotel and it is extremely important to have a proper internal control to minimize the leakage. The following points should be checked:

   (a) Effectiveness of arrangement regarding receipts and disbursements of cash.

   (b) Procedure for purchase and inventory stocking of various commodities and provisions.

   (c) Procedure regarding billing of the customers in respect of room service, telephone, laundry, etc.

   (d) System regarding recording and physical custody of edibles, wines, cigarettes, crockery and cutlery, linen, furniture, carpets, etc.

   (e) Ensure that are trading accounts are prepared preferably weekly, for each sales point. A scrutiny of the percentage of profit should be made, and any deviation from the norms is to be investigated.

(ii) **Room Sales and Cash Collections:**

   (a) There are various sales points scattered in a hotel and sales are both for cash and credit. The control over cash is very important. The charge for room sales is made from the guest register, and tests are to be carried out to ensure that the correct numbers of guests are charged for the exact period of stay. Any difference between the rate charged to the guests and standard room rent is to be investigated to see that it is properly authorized.

   (b) The total sales reported with the total bills issued at each sales point have to be reconciled.

   (c) Special care must be taken in respect of bills issued to customers who are staying in the hotel, because they may not be required to pay the bills immediately in cash but at a future date or by credit cards. Billing is to be done room-wise. It must be ensured that all customers pay their bills on leaving the hotel or within specified dates.

(iii) **Inventory:** the inventories in a hotel are all saleable item like food and beverages. Therefore, following may be noted in this regard:

   (a) All movement and transfer of inventories must be properly documented.

(b) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.

(c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(d) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.

(e) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the yearend physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

(iv) **Fixed Assets:** The fixed assets should be properly depreciated, and the Fixed Assets Register should be updated.

(v) **Casual Labour:** In case the hotel employs a casual labour, the auditor should consider, whether adequate records have been maintained in this respect and there is no manipulation taking place. The wages payment of the casual labour must also be checked thoroughly.

(vi) The compliance with all statutory provisions, and compliance with the Foreign Exchange Regulations must also be verified by the auditor, especially because hotels offer facility of conversion of foreign exchange to rupees.

(vii) Other special aspects are to be verified as under:

(a) Consumption shown in various physical inventory accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.

(b) All payments to the foreign collaborator, it any, are to be checked.

(c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.

(d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, boutiques, and special shows should be verified with the arrangements made.

(e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.

(f) The occupancy rate should be worked out, and compared with other similar hotels, and with previous year. Material deviations should be investigated.

(g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.

(h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.

(i) Apart from control over inventory of edibles, control over issue and physical inventory of linen crockery, cutlery, glassware, silver, toilet items, etc. should be verified.

(j) The auditor should verify the restaurant bills with reference to KOT (Kitchen order Ticket).

(k) The auditor should ensure that all taxes have been included in the client's bills.

(l) Computation and payment of salaries and wages vis-a-vis number of employees must be checked.

Question 13

Write short notes on "Powers of C & AG in connection with the performance of his duties".

(5 Marks, November, 2009)

Answer

Powers of Comptroller and Auditor General in connection with the performance of his duties:

(i) To inspect any office of accounts under the control of the union or a State Government including office responsible for creation of initial or subsidiary accounts.

(ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(iii) To put such questions or make such observations as he may consider necessary to the person in-charge of the office and to call for such information as he may require for preparation of any account or report, which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transaction as he may determine.

Question 14

What steps would you take in to consideration in auditing the receipts from patients of a Hospital? *(6 Marks, November, 2008)*

Answer

Audit of Receipts of a Hospital:

(i) Examine the internal check system as regards the receipts of bills from the patients.

(ii) Vouch the register of patients with copy of bills issued to them.

(iii) Verify bills for a selected period with the patient's attendance record to see that the bills have been correctly repaired.

(iv) See that bills have been issued to all the patients according to the rules of the hospital.

(v) Check cash collections as entered in the cash book with the receipts, counterfoils and other evidence.

(vi) Compare the total income with the amount budgeted for the same and report to the management for significant variations which have been taken place.

Question 15

State any six important points to be examined by you, as an auditor, in verifying the correctness of bank balance of an Educational Institution which deposits all its collection/receipt in separate collection account of a bank. *(6 Marks, May, 2008)*

Answer

Audit of Bank Balance of an Educational Institution: For verifying the balances lying with bank in collection account, the auditor should adopt following procedure:

(i) Examine and compare the pay-in-slips with the entries in the ledger account of the educational institute.

(ii) Check the casting, carry forwards and balancing of ledger account.

(iii) Compare the entries in the ledger account with the bank statement.

(iv) Review the bank reconciliation statement for its correctness.

(v) Scrutiny the subsequent period bank statement to ensure that items of reconciliation are subsequently cleared.

(vi) Verify the balance confirmation certificate.

Question 16

Write short note on "Audit against Rules and Orders". *(5 Marks, May, 2008)*

Answer

Audit against Rules and Orders: Audit against rules and order aims to ensure that expenditure conforms to relevant laws, rules, regulations and orders. It is the function of audit to carry out examination of the various rules, orders and regulations to see that:

(i) They are not inconsistent with any provisions of the constitution or any law made thereunder.

(ii) They are consistent with the essential requirements of audit and accounts as determined by C&AG.

(iii) They do not come in conflict with the orders of, or rule made by, any higher authority.

(iv) In case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Question 17

State any five special points which you, as an auditor, would look into while examining the income and collection of fund by an NGO engaged in providing relief work for flood victims.

(5 Marks, November, 2007)

Answer

Audit of Income and Collection of Fund by a N.G.O.: Five special points to be looked into are:-

(i) Grant donations and contributions received from various Government, other NGO, industry and public should be checked with reference to the grant letter, bank statements and ensured that they are properly accounted and banked.

(ii) Foreign contribution received should be checked with reference to the correspondence receipt issued, bank statement, conversion into local currency. It should be ensured that all such contributions are as per RBI guidelines and be kept in separate bank account.

(iii) In the case of any fund raising cultural or sports program, verify the internal control system, mode of receipt and the authority accountable. Ensure that all collections are duly receipted and deposited in the bank promptly.

(iv) Check the fee received from members with the register of members.

(v) Check interest and dividend received from investments with investment held.

Question 18

Write short notes on "Power of CAG Under Section 619(3) in relation to audit of Government Company". (5 Marks, November, 2007)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 19

You are approached by a partnership firm to list out the advantages that will accrue to them, if the accounts are audited. State five important advantages. (5 Marks, May, 2007)

Answer

Advantages of Audit of Accounts of a Partnership Firm: Advantages are as follows (any five):

(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.

Question 20

Write short notes on "Government Expenditure Audit". *(5 Marks, May, 2007)*

Answer

Government Expenditure Audit: It is one of the major components of Government audit. The mains aim is to ensure that:

(i) The expenditure incurred conforms to the relevant provisions of the statutory enactments and is also in accordance with the financial rule and regulation. This is called audit against "rules and orders".

(ii) There is proper sanction either special or general accorded by the competent authority for all expenditure. This is known as audit of sanctions.

(iii) There are provisions or budget of funds out of which expenditure can be met. This is called audit against provisions of fund.

(iv) The expenditure is incurred with due regard to broad and general principle of propriety. This is called propriety audit.

(v) That the programmes, schemes and projects where large expenditure has been incurred are being run economically and yielding results. This is known as performance audit.

Question 21

Audit of expenditure is one of the major components of Government Audit. In this context, write in brief what do you understand by:

(i) Audit against Rules and Orders

(ii) Audit of Sanctions

(iii) Propriety Audit *(6 Marks, November, 2006)*

Answer

(i) Audit against Rules and Orders: Audit against rules and orders aims to ensure that expenditure conforms the relevant provisions of the constitution and of the laws and rules made there under. It also seeks to satisfy the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. It includes:

(1) Rules and orders regulating the powers to incur and sanction expenditure

(2) Rules and orders dealing with the mode of presentation of claims against Government and in general the financial rules prescribing the detailed procedure to be followed by Govt. servants in dealing with Government transactions and

(3) Rules and orders regulating the conditions of services, pay and allowances, and pensions of Govt. servants.

(ii) Audit of Sanctions: The auditor has to ensure that each item of expenditure is covered by sanction, either general or special from the competent authority. The audit of sanction is directed both in respect of ensuring that:

(1) The expenditure is properly covered by a sanction and

(2) to satisfy that the authority sanctioning it, is competent for the purpose by virtue of powers vested by constitution

(iii) Propriety Audit: It means to bring out cases of improper, avoidable or infractious expenditure, even though the expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit in so far as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. Audit against propriety which are as under:

(1) The expenditure should not be prima-facie more than the occasion demands.

(2) No authority should exercise its powers of sanctioning expenditure to pass an order which will directly or indirectly to its own advantage.

(3) Public money should not be utilised for the benefit of particular person or section of the community.

Question 22

What special steps are involved in audit of a Cinema Hall? (10 Marks, November, 2006)

Answer

Special steps involved in audit of a Cinema Hall:

(i) Verify -

(a) that entrance to the cinema hall is only through printed tickets;

(b) tickets are serially numbered and bound into books;

(c) that the number of tickets issues for each show and class are different;

(d) that for advance booking a separate series of tickets is issued; and

(e) inventory of tickets is kept in proper custody.

(ii) If tickets are issued through computer- audit the system to ensure its reliability and authenticity of data generated by it.

(iii) System should provide that at the end of each show a proper statement should be prepared and cash collected be tallied.

(iv) Cash collected is deposited in banks partly on the same day and rest on the next day – depending upon the banking facility available.

(v) Verify that proper record is kept for free passes issued and the same are issued under proper authority.

(vi) Cross check the entertainment tax deposited.

(vii) Verify the income from advertisements and slides showed before the show.

(viii) Vouch the expenditure incurred on publicity of picture, maintenance of hall, electricity expenses etc.

(ix) Vouch recoveries of advertisement expenses etc from film distributors.

(x) Vouch payment of film hire with reference to agreement with distributor or producer.

(xi) Verify the basis of other incomes earned like restaurant, car and scooter parking and display windows etc.

(xii) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate which are higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

Question 23

(a) What are the special considerations in an audit of a Limited Company?

(b) Explain propriety audit in the context of Government Audit. (8 Marks each, May, 2006)

Answer

(a) Special Consideration in Audit of a Limited Company:

(i) Initial Verification

(a) Examine basic documents, viz., Memorandum of Association and Articles of Association of the company, prospectus issued, etc.

(b) Check the certificate of incorporation and certificate of commencement of business.

(c) Examine transactions entered into by the company with reference to the date of these certificates.

(d) Verify the contracts entered into with vendors or other persons for purchase of property, payment of commission, etc.

(ii) Board's Duties

(a) Ensure that Board of Directors act well within their powers and no ultra vires act is ratified.

(b) Also check that the Board has not exercised the powers that are to be exercised by the members in their General Meeting.

(c) Verify that only acts that can be delegated are in fact delegated to others and that the Board takes decisions only by resolutions at properly constituted meetings.

(d) Inspect minutes of meetings of Board of Directors.

(e) Verify whether the Board has obtained sanction of the Central Government, wherever applicable, e.g., increase in remuneration to Directors in excess of specified amounts.

(iii) Compliance with relevant provisions of the Companies Act, 2013 relating to share capital; provision relating to Board, provisions relating to accounts and audit, etc.

(iv) Compliance with provisions relating to section 139 to 148 of the Companies Act, 2013.

(b) Propriety Audit: Under 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. However, some general principles have been laid down in the Audit Code, which have for long been recognized as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(i) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(ii) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(iii) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(a) the amount of expenditure involved is insignificant; or

(b) a claim for the amount could be enforced in a Court of law; or

(c) the expenditure is in pursuance of a recognised policy or custom; and

(d) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Question 24

How the audit is advantageous to Sole Trader? *(8 Marks, May, 2006)*

Answer

Advantages of Audit to a Sole Trader: Although sole traders are not required by any law (except u/s 44AD, 44AE, 44AF, 44AB and other provisions of the Income-tax Act, 1961) to have their accounts audited, yet it has become customary for many of them who derive their large incomes from numerous sources and whose expenditure is vast and varied to get their accounts audited. Also, sole traders, get their financial statements audited due to regulatory requirements, such as stock brokers or on a specific instructions of the bank for approval of loans, etc. The sole trader can determine the scope of the audit as well as the conditions under which it will be carried out. For example, he can stipulate that only a partial audit shall be carried out or certain parts of the accounts shall not be checked. It will also be decided that the audit will be carried out continuously or at the end of the year. Thus, the duties and the nature of auditor's work will depend upon the agreement that he has entered into with the sole trader. But he must obtain clear instructions from his clients in writing as to what he is expected to do. The following are some of the advantages that can be derived from an audit of this nature:

(i) The individual is assured of having his accounts properly maintained and his expenditure vouched.

(ii) He is also assured of not being defrauded by the accountant and his agents. Even if they have done some defalcations, etc. these may be discovered by the auditors.

(iii) The audited accounts are reliable and are generally accepted by the Income-tax Department and hence, individuals do not feel any difficulty for taxation assessments, etc.

(iv) The audited accounts of a deceased are very helpful for executors and administrators.

Question 25

What are the powers of C&AG in relation to the accounts of Government Companies audited by the statutory auditors? (8 Marks, November, 2005)

Answer

Powers of C&AG in Relation to Government Companies: Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,

(i) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, 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 Comptroller and Auditor-General of India may direct; and

(ii) comment upon or supplement such audit report:

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

Question 26

What special steps will you take into consideration in auditing the receipts from entry fees of an amusement park? Mention any four points specific to the issue. (4 Marks, November, 2005)

Answer

Audit of receipts from Entry Fees of an Amusement Park:

(i) Evaluate the internal control system regarding entry and collection for entry tickets including rotation of staff.

(ii) Ensure that tickets are pre numbered.

(iii) Ensure that the deposit of cash collected into the bank account very same next day.

(iv) Compute analytical ratios in respect of the receipts pattern i.e. on weekends, holidays, etc. and make comparisons to draw conclusions.

Question 27

With reference to Government Audit, what do you understand by "Audit of Commercial Accounts"? (8 Marks, May, 2005)

Answer

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 statues such as LIC, Air India, etc.

(iii) Government companies, set up under the Companies Act, 2013.

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, 2013 are applicable.

Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,

(i) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, 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 Comptroller and Auditor-General of India may direct; and

(ii) comment upon or supplement such audit report:

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

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 C&AG. 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.

Question 28

Describe the salient features of Financial Administration of Local Bodies.

(8 Marks, November, 2004)

Answer

Salient Features of Financial Administration of Local Bodies:

(i) **Budgetary Procedure:** The objective of local bodies budgetary procedure are financial accountability, control of expenditure, and to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or Council. Different aspects covered in budgeting are determining the level of taxation, fees, rates, and laying down the ceiling on expenditure, under revenue and capital heads.

(ii) **Expenditure Control:** At the State and Central level, there is a clear demarcation between the legislature and executive. In the local body, legislative powers are vested in the Council whereas executive powers are delegated to the officers, e.g., Commissioners. All matters of regular revenue and expenditures are generally delegated to the executive wing. For special situations like, reduction in property taxes, refund of security deposits, etc., sanction from the legislative wing is necessary.

(iii) **Accounting System:** Municipal Accounting System has been conventionally prepared under the cash system. In the recent past however, it is being changed to the accrual system of accounting. The accounting system is characterised by (a) subsidiary and statistical registers for taxes, assets, cheques etc., (b) separate vouchers for each type of transaction, (c) compulsory monthly bank reconciliation, (d) submission of summary reports on periodical basis to different authorities at regional and state level.