PAPER – 6 : AUDITING AND ASSURANCE

QUESTIONS

1. State with reasons (in brief) whether the following statements are ***True*** or ***False***.

   (i) It is auditor's responsibility to maintain an adequate accounting system incorporating various internal controls.

   (ii) The risk of not detecting error is more than the risk of not detecting fraud.

   (iii) Basically, an auditor reports on the truth or otherwise of the financial statements; prevention and detection of frauds and errors are secondary to this.

   (iv) Fraud means misappropriation of goods or cash and artificial manipulation of accounts.

   (v) In case of audit of partnership or sole proprietorship, the auditor's duties are defined purely by the contract between him and the client.

   (vi) The auditor may, in planning the audit work, intentionally see the cut-off level for verifying individual transactions at a lower level than in intended to be used to evaluate the results of the audit.

   (vii) If the directors are of the opinion that any fixed asset does not have a realisable value at least equal to its book value, the fact should be stated in the accounts.

   (viii) Interest accrued but not due on "Investments" is required to be shown under appropriate sub-heads under the head "Investments".

   (ix) An auditor holds office till the due date of the next annual general meeting as determined by Sections 166 and 210 of the Companies Act, 1956.

   (x) In extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor should express a disclaimer of opinion.

   (xi) A company may maintain its books of accounts according to either mercantile system of accounting or cash system of accounting but not mixed system.

   (xii) An employee of the company cannot be appointed as auditor of its branch under section 228.

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

   (a) In case the existing auditors reappointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy?

   (b) At the AGM of a company, in which a Nationalised Bank held 25% of the subscribed capital, Krishna & Co., Chartered Accountants, were appointed as auditor by passing an ordinary resolution.

   (c) The members of C Ltd. preferred a complaint against the auditor stating that he has failed to send the auditors report to them.

(d) One of the directors of Hitech Ltd. is attracted by the disqualification under Section 274(1)(g).

3. 'In vouching payments, the auditor does not merely check proof that money has been paid away.' Discuss.

4. As an auditor, what would you do in the following situations ?

   One customer from whom Rs.4 lakhs are recoverable for credit sales gives a motor car in full settlement of the dues. The directors estimate that the market value of the motor car transferred is Rs.4.20 lakhs. As on the date of the balance sheet the car has not been registered in the name of the auditee.

5. (a) Reena Ltd received Rs.50 lakhs as grant from the State Government towards the part cost of a specific machinery. The company credited the above sum of Rs.50 lakhs as income in its profit and loss account for the year. What are your views on the accounting treatment of the above receipt of Rs.50 lakhs?

   (b) As an Auditor, comment on the following situation/statement:

   JKT Ltd. having Rs.40 lacs paid up capital, Rs.9.50 lacs reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being Rs.4.90 crores, Rs.4.50 crores and Rs.6 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory.

6. State with reasons your views on the following:

   (a) Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2002-2003. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.

   (b) Mr. Ramadas, a fellow member of the Institute of Chartered Accountants of India, working as Manager of Sivram & Co., a Chartered Accountant firm, signed the audit report of Om Ltd. on behalf of Sivram & Co.

7. How will you, as an auditor, verify and value the following ?

   (a) Preliminary expenses

   (b) Discount on issue of shares or debentures

   (c) Contingent assets

   (d) Liabilities

8. Write short notes on the following:

   (i) Auditing around the computer

   (ii) Auditing through the computer

9. Comment on the following:

   (i) While finalising an audit you have to decide whether it is necessary to disclose receivables written off or advances written back as a separate item in the financial statements. How will you proceed?

(ii) Materials have been issued on loan to other companies or contractors. Should such materials be disclosed under inventories or under the head 'loans and advances'?

(iii) A company has disclosed the figures for raw materials consumption required to be disclosed in the notes to the profit and loss statement vide Schedule VI to the Companies Act on working back or derived basis, i.e., by deducting closing stock from the sum of opening stock and purchases.

(iv) A company has included shortages, losses and wastage in the figures for raw materials consumption required to be disclosed in the notes to the profit and loss statement vide Schedule VI to the Companies Act.

10. Give your comments on "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.

11. 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, 2009. The sales ledger balance at 31st March, 2009 was Rs.90,000. By 20th July 2009 Rs.55,000 only had been received against this amount as full and final payment.

12. An auditor intends to use a Generalised Audit Software (GAS) application for creditors. Explain with the help of an example, the steps the auditors should take in this regard.

13. The management of Anita Limited suggested for quick completion of the statutory audit that it would give its representation about the receivables in terms of their recoverability. The management also acknowledged to the auditors that the management would give their representation after scrutinizing all accounts diligently and they own responsibility for any errors in these respects. It wanted auditors to complete the audit checking all other important areas except receivables. The auditor certified the account clearly indicating in his report the fact of reliance he placed on representation of the management.

14. How the work of an expert should be evaluated before accepted the same as an Audit evidence ?

15. (a) How does an auditor audit Government Expenditure?

    (b) What categories of Companies are specifically exempted from the application of Companies (Auditor's Report) Order, 2003?

16. (a) 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".*

(b) As a company auditor how would you react to the following situation? Rs. 5 lakhs paid by a pharma company to the legal advisor defending the patent of a product treated as capital expenditure.

17. Mention the special steps involved in the audit of an Educational Institution.

18 Mention the special points in the case of an audit of the entity from Incomplete Records.

19. Mention any eight special points which you as an auditor would look into while auditing the books of a partnership firm.

20. Comment on the "Responsibility for properly determining the quantity and value of inventories rests with the management of the entity".

SUGGESTED ANSWERS/HINTS

1. (i) **False:** As per SA 200, it is management's responsibility and not auditor's responsibility.

(ii) **False:** Fraud is more difficult to detect than error. This is because fraud generally involves sophisticated and carefully organized schemes to conceal it such as Forgery, Deliberate failure to record transaction, International misrepresentations to the auditor.

(iii) **False:** The main objects of any audit are: (a) To certify the correctness of the financial position as shown in the balance sheet and the accompanying revenue statements, (b) detection of errors, (c) detection of fraud. [*STPAM's case, (2008) 170 Taxman 371 (Bom.); Frankston and Hastings Corporation v. Cohen (1960) 102 CLR 607*].

(iv) **True:** From the auditor's point of view, fraud means misappropriation of goods or cash and artificial manipulation of accounts. (SA 240)

(v) **True:** No basic legal requirement for audit. So, auditor's duties and rights are a matter of contract.

(vi) **True:** This may be done to cover a large number of items and thereby reduce the likelihood of undiscovered frauds, errors. It would provide the auditor with the margin of safety when evaluating the effect of misstatements discovered during the audit.

(vii) **False:** This requirement of Part I Schedule VI to the Companies Act, 1956 applies to Current Assets, Loans and Advances and not to Fixed Assets.

(viii) **False:** Interest accrued on "Investments" (whether due or not) should be shown under the head "current Assets, Loans and Advances" under the sub-head "Current Assets" as the very first item "Interest accrued on investments".

(ix) **False:** He (auditor) holds office until the conclusion of the next AGM Section 224(1).

(x) **False:** As per SA 700, the auditor should consider expressing a disclaimer of opinion (and if he believes it is necessary in circumstances, he should express a disclaimer of opinion).

(xi) **False:** A company may maintain its books of account according to the double entry system of accounting [Section 209(3)].

(xii) **True:** An employee of the company cannot be appointed as auditor of its branch under Section 228.

2. (a) Refusal by Auditors to Accept the Reappointment: Section 224(3) of the Companies Act, 1956 empowers the Central Government to fill a vacancy in case no auditors are appointed or reappointed at an annual general meeting. Since the appointment of an auditor is complete only on the acceptance of the office by the auditor, it can be deemed that in case an auditor refuses to accept the appointment then in that case no auditor has been appointed and the Central Government may appoint a person to fill the vacancy as provided in Section 224(3). Thus, the non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. As a general principle, the shareholders have to exercise this power in all cases, except in the case of filling a casual vacancy or appointing the first auditors. Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditors appointed at the AGM refuse to accept the appointment.

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

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

(c) Dispatch of Auditor's Report to Shareholders: Section 227 of the Companies Act, 1956 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to members of the company. The auditor's duty concludes once he forwards his report to the company. It is the responsibility of company to send the report to every member of the company. In Re Allen Graig and Company (London) Ltd., 1934 it was held that duty of the auditor after having signed the report to be annexed to a balance sheet is confirmed only to forwarding his report to the secretary of the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

(d) **Disqualification of a Director u/s 274(1)(g) of the Companies Act, 1956:** Section 227(3)(f) as inserted by the Companies (Amendment) Act, 2000 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as directors under Section 274(1)(g) of the Companies Act, 1956. To this end, the auditor has to ensure that written representation have been obtained by the Board from each director that one is not hit by Section 274(1)(g). Since in this case, one of the director is attracted by disqualification u/s 274(g) of the Act, the auditor shall state in his report u/s 227 about the disqualification of the particular director.

3. Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching the payments of a business is not merely to ascertain that money has been paid away; but the auditor aims to obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account that –

(i) a transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period;

(ii) a transaction pertains to entity and took place during the relevant period;

(iii) all transactions which have actually occurred have been recorded;

(iv) all transactions were properly authorised; and

(v) transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transaction in the context of the client's business, nature of the organisation and organisational rules.

Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy but also to see its substantial accuracy and then to make a report thereon.

This substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records

4. **As per AS 10**

I. When a fixed asset acquired in exchange for another asset:

(i) Its cost is (usually) determined by reference to the fair market value of the consideration given.

(ii) It may be appropriate to consider also the fair market value of the asset acquired if this is more evident.

II. An alternative accounting treatment which is used is that:

When assets exchange are similar to record the assets acquired at net book value of the asset given up. In each case, an adjustment is made for any balancing receipt or payment of cash or other consideration.

In the given case, the company has acquired a motor car by exchange of an amount due from him.

Determination of ownership

(i) Proof of payment of consideration by the customer

(ii) Possession of assets by him is sufficient to determine ownership of the car.

Registration is only a permission given to the vehicle under the Motor Vehicles Act to ply on the road and it does not determine the ownership.

Valuation of car

(i) It will be valued at 4,00,000 because the value of asset given up is more clearly evident than the fair market value of the asset acquired.

(ii) Hence, it should be valued at Rs.4,00,000 and the asset account should be debited at Rs.4,00,000 and the customer account credited at Rs.4,00,000.

(iii) In case, the directors revalue the asset at Rs.4,20,000 then the excess of Rs.20,000 shall be treated as Revaluation revenue.

5. **(a) AS 12:** Accounting for government grants regards two methods of presentation of grants related to specific fixed assets in financial statements as acceptable alternatives:

(i) Under first alternative, the grant is shown in the Balance Sheet as a deduction from the gross value of a machinery. The grant is recognized in P& L A/c over the useful life of a depreciable asset by way of a reduced depreciation charges.

(ii) Under second alternative, it can be treated as deferred income which should be recognized in P & L A/c over useful life of asset in proportion in which depreciation on machinery will be charged. The deferred income pending its apportionment to P & L A/c should be disclosed in Balance Sheet with a suitable description e.g. Deferred Government Grants.

In the given case, Reena Ltd. received Rs.50 lakhs as grant towards part cost of specific machinery. The company has credited the said sum as income in its Profit and Loss account which is incorrect. As the treatment is not in accordance with Accounting Standard so company is advised to rectify as per provision given above.

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

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

a. The company has a paid-up capital and reserves exceeding Rs.50 lakhs at the commencement of the financial year, or

b. The company has an average annual turnover of Rs.5 crores or more for a period of 3 years preceding the current financial year.

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

6. (a) Auditor holding securities of a company : As per sub-section (3)(e) of Section 226, a person holding any security of the company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000 w.e.f. December 13, 2001 is not qualified for appointment as auditor of that company. For the purpose of this section, “security” means an instrument which carries voting rights.

It is further laid down in sub-section (4) of Section 226 that a person is not eligible for appointment as auditor of any company, if he is disqualified from acting as auditor of that company’s subsidiary or holding company or of any other subsidiary of the same holding company. Sub-section (5) of Section 226 provides that if an auditor, after his appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4), he shall be deemed to have automatically vacated his office.

A firm would also be disqualified to be appointed as an auditor even when one partner is disqualified under clause (e) of sub-section (3) of Section 226.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. As such, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd., which is the holding company of Shiva Ltd., even when one partner is disqualified under this clause.

(b) Signature on Audit Report: Section 229 of the Companies Act, 1956 requires that only a person appointed as the auditor of the company or where a firm is so appointed, a partner in the firm practising in India, may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor. Therefore, Mr. Ramdas, a fellow member of the Institute and a manager of M/s Sivram & Co., Chartered Accountants, cannot sign on behalf of the firm in view of the specific requirements of the Companies Act, 1956. If any auditor's report or any document of the company is signed or authenticated otherwise than in conformity with the requirements of Section 229, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document shall, if the default is willful, be punishable with a fine.

7. (a) ***Preliminary expenses*:** The expenses incurred for the formation and commencement of a company is usually grouped under the heading "preliminary expenses". These include stamp duties, registration fees, legal costs, cost of printing etc.

In order to verify preliminary expenses, the auditor should take into consideration the following matters:

(i) It should be seen by the auditor that no expenses other than those related to the formation of a company are included under this head.

(ii) The auditor should examine the contracts relating to preliminary expenses. If preliminary expenses that were incurred by the promoters have been reimbursed to them by the company, the resolution of the board and the power in the articles to make such payment should be considered.

(iii) The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet.

(iv) Being a fictitious asset, it should be written off as early as possible and the auditor should verify that the balance of preliminary expenses which has not been written off is shown in the balance sheet under the heading "miscellaneous expenditure".

(v) Underwriting commission and brokerage in shares and debentures should not be included under the head "preliminary expenses". The auditor should also confirm this aspect.

(vi) The bills and statements supporting each item of preliminary expenses should be checked.

(vii) The auditor should also ensure that proper deduction has been availed against taxable income under the Income Tax Act, 1961.

(b) ***Discount on Issue of Shares or Debentures*****:** This refers to the expenditure or losses essentially of a revenue nature, which instead of being charged off as and when incurred, is accumulated in an account and the balance in the account is written off over a period of years during which its benefit is expected to accrue to the business.

In order to verify the discount on issue of shares or debentures, the auditor should pay attention to the following matters:

(i) The auditor should confirm that it continues to appear as an asset on the right side of the balance sheet as along as the discount is not written off.

(ii) If during the year, any amount has been added thereto, the auditor should ask for the justification of the same.

(iii) Being a fictitious asset, it should be written off as early as possible. The auditor should also confirm this aspect.

(iv) The auditor should see that the discount on issue of shares or debentures has been shown separately under the heading 'Discount on Issue of Shares or Debentures'.

(v) In issuing shares or debentures at a discount, whether the governing provisions relating to issue of shares and debentures have been duly complied with or not should also be checked by the auditor.

(c) ***Contingent Assets*****:** The contingent assets are those which may arise on the happening of an uncertain event. As a general practice, contingent assets are not recorded in the balance sheet because that would imply taking credit for revenue which has not accrued. But it is logical as the contingent liabilities are shown in the balance sheet the contingent assets should also be shown. The Companies Act does not require disclosure of contingent assets in the balance sheet. However, if contingent asset have a significant value, it may be advisable to disclose such assets in a note to the balance sheet.

As regards valuation of contingent assets, it may be noted that ordinarily no valuation would be required. However, if such assets were disclosed by way of a note, a proper valuation based on the related contract would be made. Where full realization of such assets is doubtful even on the face of contingency occurring, it would be safer to value the assets on a realisable basis.

(d) ***Liabilities*****:** The verification of liabilities is of equal importance as that of an asset. The auditor has to satisfy himself that all liabilities whether existing or contingent have been properly determined and disclosed in the balance sheet. In case liabilities are overstated or understated, the balance sheet will not represent a fair view of the state of affairs of the company. Therefore, the auditor should ensure the following:

- That liabilities shown in the balance sheet are actually payable
- That all liabilities are properly recorded in the books

- That the recorded liabilities are payable for the legitimate operations of the business, and
- That the nature and extent contingent liabilities have been disclosed in the balance sheet by way of a footnote.

For the purpose of applying verification technique, we may divide the liabilities into the following three categories:

- Fixed or long term liabilities, viz. share capital, debenture, long term loan from bank and other financial institutions etc.
- Current liabilities, viz. sundry creditors, bills payable, bank overdraft etc.
- Contingent liabilities viz. disputed liability of income tax suits pending for damages etc.

8. (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:

(i) The system is simple and uses generalised software that is well tested and widely used.

(ii) Processing mainly consists of sorting the input data and updating the master file in sequence.

(iii) Audit trail is clear. Detailed reports are prepared at key processing points within the system.

(iv) 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 generalised 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:

(i) The organisation has developed either in house or through a reputed vendor, a software package suitable to its requirement, because of inability of a generalised package to cater to the complex nature of transactions.

(ii) The system processes very large volumes of output. This makes examination of validity of input and output difficult.

(iii) 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.

(iv) 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.

9. (i) Receivable written of is an item of expenditure and needs to be disclosed separately as per schedule VI, if the amount exceeds Rs.5,000 or 1 per cent of the total revenue. Advances written back is an item of income and needs to be disclosed separately if it is considered material in terms of Accounting Standard - 1 (Disclosure of Accounting Polices). [Refer expert advisory opinion by ICAI].

(ii) Material given on loan cannot be classified as inventories because they do not fulfil the requirements of the definition of inventory under Accounting Standard - 2. Further, loan can be either in cash or in kind. In view of this, the materials given as loans should be classified under the head loans and advances. [Refer expert advisory opinion by ICAI].

(iii) In view of the specific requirement of Schedule VI for disclosure of actual consumption, the company is required to maintain actual issue records of raw materials and not work back or derive the consumption figures arithmetically. [Refer Statement on the Amendments to Schedule VI to the Companies Act, 1956 by the ICAI].

(iv) A company can include normal shortages, losses and wastages (but should exclude abnormal shortages, losses and wastage) in the figures for raw materials consumption required to be disclosed in the Notes to the profit and loss Statement vide Schedule VI to the Companies Act. [Refer Statement on the Amendments to Schedule VI to the Companies Act, 1956 by the ICAI].

10. As per SA 230 the working papers are the property of the auditor and the auditor has right to retain them. He may at him 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.

11. Consideration of subsequent events

SA 560 requires that the auditors should consider the effect of subsequent events on the financial statements and the auditor's report. Depending on 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 debtors as also the realisability aspect. The auditor's duties in respect of debtors remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from debtors. 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, 2009. Accordingly, the auditor would have now to see that in respect of outstanding amount of Rs.35,000, whether the amount of provision needs any revision.

12. The steps taken by an auditor using a GAS application for creditors are as follows:

(a) The objectives of application:

- ➢ Test the mathematical accuracy of the creditors database.
- ➢ Select for confirmation all creditors account with balances greater than Rs.10,000 plus a random sample of 50 accounts with balances less than Rs.10,000.
- ➢ Print out the confirmation and monthly statement for all selected accounts.

(b) Design the application:

- Identify the data structures used in the database.
- Specify the format for the confirmation.

(c) Code the instruction for the application:

- Enter the code directly into the GAS for the confirmation application.

(d) Process the application:

- Access the client's creditors' database with the GAS. Generally, a work file is extracted from the database for processing on the GAS.

(e) Evaluate the results of the application:

- Verify the output that tested the mathematical accuracy of the creditors' database.
- Review the confirmations and monthly statements.
- Mail confirmations and monthly statements to creditors.

13. The management of Anita Limited wants the auditor to carry out audit on all areas, except on area of receivables. There cannot be any restriction on scope of audit in case of statutory audit.

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

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

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

14. An expert is a person, firm or other association of persons possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

When the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and other matters such as:

1. objectiveness and scope of expert's work
2. a general outline as to the specific items in the expert's report
3. confidentiality of the expert's work, including the possibility of its communication to third parties
4. the expert's relationship with the client
5. confidentiality of client's information used by the expert.

Evaluation of expert's work:

Appropriate audit evidence: Auditor should seek reasonable assurance that expert's work constitutes appropriate audit evidence by considering:

1. source data used
2. the assumptions and methods used and their consistency with prior period the result's of expert's work
3. the auditor should also satisfy himself that substance of the expert's findings is properly reflected in the financial information.

Date used by expert: The auditor should consider whether the expert has used appropriate source data by employing procedures like:

1. Inquiring expert to determine how he has satisfied himself the expert has used appropriate source data are sufficient, reliable and relevant.
2. Considering audit procedures on the data provided by the client to the expert to obtain reasonable assurance that data are appropriate.

Assumptions adopted by expert: The auditor should obtained an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of client's business and results of his audit procedures.

15. (a) Audit of Government Expenditure

Audit of expenditure of government organization or department is conducted by the Comptroller and Auditor General (C & AG) of India. It is a major constituent of the government audit. The basic standards established for expenditure audit are to confirm that there is provision for funds authorised by the competent authority setting the limits within which expenditure can be incurred. These standards are as follows:

(1) The expenditure incurred comply with the relevant provisions of the law and according to the Financial Rules and Regulation constructed by the competent authority. Such audit is known as audit against rules and orders.

(2) There is either special or general sanction allowed by the competent authority authorising the expenditure. Such an audit is known as audit of sanctions.

(3) There is provision for funds out of which expenditure is incurred and also it is authorized by the competent authority. Such audit is known as audit against provision for funds.

(4) The expenditure has been incurred with due regards to the broad and general principles of the financial propriety. Such audit is known as audit against propriety audit.

(5) Various programmes scheme and project in which huge financial expenditures have been incurred or being run economically and are yielding results expected from them. Such audit is known as performance audit.

The propriety audit and performance audit suggest completely, a different approach, adopted by the C & AG as against the regulatory audit. In the propriety audit the C & AG brings out the cases of avoidable, improper or unfruitful expenditure even though the expenditure has been incurred in compliance with the existing rules and regulations.

Performance audit goes even a step ahead and has a quite comprehensive approach as it includes 3 Es i.e. efficiency, economy and effectiveness.

(b) Application of CARO, 2003: The Companies (Auditor's Report) Order, 2003 is applicable to all types of companies but it provides that it shall not apply to:

(i) a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949;

(ii) an insurance company as defined in clause (21) of Section 2 of the Companies Act, 1956;

(iii) a company licensed to operate under Section 25 of the Companies Act, 1956; and

(iv) a private limited company with a paid-up capital and reserves of not more than rupees fifty lakhs and which does not have outstanding loan exceeding rupees twenty five lakhs from any bank or financial institution and does not have a turnover exceeding rupees five crores at any point of time during the financial year. Thus, a private limited company, in order to be exempted from the applicability of the order, must satisfy all the conditions cumulatively.

16. (a) Appointment of Special Auditor: Section 233A of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted.

Amongst others, one of the circumstances specified is in case a company is not being managed in accordance with some business principles or prudent commercial practices. Further the said section also provides that for the purpose, it may appoint a chartered accountant, whether or not the chartered accountant is in practice, or the company's auditor itself to conduct such special audit.

Therefore, the appointment of Mr. Sushil, a non-practising member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Mr. Ajay M.D. is not correct.

(b) Expenditure made by a pharma company to the legal advisor

Expenses of Rs. 5 lakhs made by a pharma company to the legal advisor are legal expenses. Such expenses are incurred for defending the patent of a product of the pharma company is a revenue expenditure relating to the asset because it neither enhance the capacity of the asset nor any endurable benefit is obtained in future in addition to what is available at present. The legal fees paid is normally an expenditure in the revenue nature irrespective of the amount unless it is incurred for bringing any new assets in existence. Therefore, it is not correct to treat the expenditure as capital expenditure. It would result tin the overstatement of assets value and profit and calls for qualification in the audit report.

17. The special steps involved in the audit of an educational institution are the following:

(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 Regulations 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 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 had 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 prescribed rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' 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 papers 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 and not transferred to revenue.

(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.

(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 Stock Register 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) Verify the annual statements of accounts 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.

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

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

(i) Where records are kept on single entry basis; or

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

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

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

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

(i) Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single entry system, cash, bank, and personal accounts are maintained.

(ii) Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.

(iii) Check that all entries on the payment side of cash book are posted in the ledger.

(iv) Confirming that all entries appearing in bank account are posted in the ledger.

(v) Analyse personal accounts of debtors. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills dishonoured, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtors accounts.

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

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

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

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

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

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

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

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

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

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

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

20. The Guidance Note on Audit of Inventories specifies that the responsibility for properly determining the quantity and value of inventories rests with of the management of the entity. Therefore, it is the responsibility of the management the entity to ensure that the inventories included in the financial information 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 adequacy of the methods and procedures of physical verification followed by the entity. He is also required to determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items are well-designed and operate properly.

This responsibility of the 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 (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case. In valuation aspects, compliance with AS 2 should also be ensured.