PAPER – 6: AUDITING AND ASSURANCE

QUESTIONS

Nature of Auditing

1. (a) While auditing the accounts of XYZ Ltd., it has come to the notice of the auditor that receipts have been suppressed. Discuss explaining at least five techniques as to how receipts may be suppressed.

   (b) "The relationship between auditing and law is very close one." Discuss.

2. (a) "Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events increase the risk of fraud or error." Discuss.

   (b) "If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments." Discuss the tests applied by the courts to judicially view the auditor's performance.

3. (a) Discuss with the help of examples how certain characteristics or circumstances may increase the susceptibility of assets to misappropriation.

   (b) "In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member." Discuss.

Basic Concepts in Auditing

4. (a) "Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated." Comment

   (b) What do you understand by "Risk of material misstatement"? Describe its two components at the assertion level.

5. (a) Discuss the Objectives of an auditor as stated in SA 570 'Going Concern'.

   (b) "Because of the uncertainties inherent in business activities, some financial statement items can only be estimated." Discuss explaining the meaning of accounting estimates according to the SA 540 and also by giving examples.

6. (a) "The Companies Act, 1956 has enacted specific provisions to give concrete shape to the concept of Auditor's Independence." Discuss.

   (b) "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 as to what extent the various internal evidence corroborate each other." Discuss explaining the meaning of Internal and external evidence and distinction between them.

Preparation for an Audit

7. (a) How should an auditor proceed if there is a change in the terms of the audit engagement?

   (b) "For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques." Discuss some of the techniques commonly adopted by the auditors.

8. (a) What is an audit programme ? Discuss the points you should keep in mind for the purpose of programme construction.

   (b) "The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan." How would you as an auditor establish the overall audit strategy?

Internal Control

9. (a) What do you understand by the Internal Control ? State the objectives of Internal Control.

   (b) "The division of internal control into the five components provides a useful framework for auditors." Comment and name those components.

10. (a) Discuss the factors relevant to the auditor's judgment, about whether a control, individually or in combination with others, is relevant to the audit.

    (b) "The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level." Comment.

11 (a) Discuss the information an auditor should gather about the CIS environment that is relevant to the audit plan.

   (b) Discuss the factors to be considered by the auditor when evaluating the adequacy of the internal audit system.

Vouching & Verification of Assets and Liabilities

12. (a) Explain clearly the meaning of vouching. Also discuss the essential points to be borne in mind while examining a voucher.

    (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."

13. How will you verify/vouch the following ?

    (a) Stock lying with Third Party.

    (b) Purchase of Motor Car.

    (c) Sales Commission Expenditure.

(d) Sales Return.

14. Give your comments and observations on the following:

    (a) Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts at the year-end.

    (b) The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.

    (c) Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses.

15. Answer the following-

    (a) KVT Limited could not recover an amount of ₹ 8 lakhs from a debtor. The company is aware that the Trade receivable is in great financial difficulty. The accounts of the company for the year ended 31-3-2013 were finalized by making a provision @ 25% of the amount due from that Trade receivable. In May 2013, the Trade receivable became bankrupt and nothing is recoverable from him. Do you advise the company to provide for the entire loss of ₹ 8 lakhs in books of account for the year ended 31-3-2013?

    (b) M Co. Limited purchased goods at the cost of ₹ 40 lakhs in October, 2012. Till March, 2013, 75% of the stocks were sold. The company wants to disclose closing stock at ₹ 10 lakhs. The expected sale value is ₹ 11 lakhs and a commission at 10% on sale is payable to the agent. Accountant has disclosed the value of Stock at ₹ 990000. Give your views as an auditor.

    (c) X Co. Ltd. charged depreciation on its asset on SLM basis. For the year ended 31.3.2013 it changed to WDV basis. The impact of the change when computed from the date of the asset coming to use amounts to ₹ 20 lakhs being additional charge.

        Decide how it must be disclosed in Profit and loss account. Also discuss, when such changes in method of depreciation can be adopted by an enterprise as per AS 6.

The Company Audit

16. 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) The auditor of T Ltd. did not report on the matters specified in sub-section (1A) of Section 227 of the Companies Act, 1956, as he was satisfied that no comment is required.

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

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

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

17. Discuss in brief the power of Company to purchase its own Securities.

18. How an auditor can audit allotment of debentures?

Special Audits

19. (a) Describe the salient features of Financial Administration of Local Bodies.

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

20. With reference to Government Audit, what do you understand by "Audit of Commercial Accounts"?

SUGGESTED ANSWERS / HINTS

1. (a) Five Techniques of how receipts are suppressed are:

(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 unauthorised or fictitious rebates, allowances, discounts, etc. to customer accounts and misappropriating amount paid by them.

(iii) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(iv) Not accounting for cash sales fully.

(v) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.

(b) The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

2. (a) In planning and performing his examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are:

(i) Weaknesses in the design of internal control system and non-compliance with the laid down control procedures, e.g., a single person is responsible for the receipt of all dak and marking it to the relevant sections or two persons are responsible for receipt of dak but the same is not followed in actual practice, etc.

(ii) Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees, frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc.

(iii) Unusual pressures within the entity, for example, industry is doing well but the company is not performing accordingly, heavy dependence on a single line of product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc.

(iv) Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.

(v) Problems in obtaining sufficient and appropriate audit evidence, e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc.

(b) If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests:

(i) whether the auditor has exercised reasonable care and skill in carrying out his work;

(ii) whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts;

(iii) whether the auditor had any reason to suspect the existence of the errors and frauds; and

(iv) whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

3. (a) Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

(b) The Auditing and Assurance Standards Board, in 2007, adopted the *Revised Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services.* In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member, viz.,

(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, engagements dealing with subject matters other than historical financial information

(iv) *Standards on Related Services (SRSs)* - to be applied to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements

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

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

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

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

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

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

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

(b) Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit.

This consists of two components described as follows at the assertion level

(i) **Inherent risk**:The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.

(ii) **Control risk**: The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

5 (a) The objectives of the auditor as stated in SA 570 'Going Concern' are:

(i) 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;

(ii) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(iii) To determine the implications for the auditor's report.

(b) 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.

6. (a) The following points would reflect that the Companies Act, 1956 has enacted specific provisions to give concrete shape to this vital concept of auditor's independence.

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

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

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

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

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

(b) Internal and External Evidence- Evidence which originates within the organisation being audited is internal evidence. Example-sales invoice, Copies of sales challan and forwarding notes, goods received note, 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 organisation; for example, purchase invoice, supplier's challan and forwarding 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 as to what extent the various internal evidence corroborate each other.

Preparation for an Audit

7. (a) If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

   If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

   (i) Withdraw from the audit engagement where possible under applicable law or regulation; and

   (ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

   (b) 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

8. (a) An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view:

   (i) Stay within the scope and limitation of the assignment.

   (ii) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

   (iii) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

(iv) Consider all possibilities of error.

(v) Co-ordinate the procedures to be applied to related items.

(b) The auditor shall establish an overall audit strategy that sets the scope, timing and direction 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.

9. (a) As per SA 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" the internal control may be defined as "The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control."

Objectives of Internal Control:

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(iii) assets are safeguarded from unauthorised access, use or disposition; and

(iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

(b) Division of internal control into components: The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(i) The control environment;

(ii) The entity's risk assessment process;

(iii) The information system, including the related business processes, relevant to financial reporting, and communication;

(iv) Control activities; and

(v) Monitoring of controls.

10. (a) Factors relevant to the auditor's judgment, about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organisation and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

(b) The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level. In this regard the auditor would consider:

(i) the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;

(ii) the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and

(iii) the extent of substantive procedures, for example, using a larger sample size.

11. (a) 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:

(vi) 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.

(vii) Planning how, where and when the CIS function will be reviewed including scheduling the works of CIS experts, as applicable.

(viii) Planning auditing procedures using computer-assisted audit techniques.

(b) The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:

(i) What is the size of the internal audit department?

(ii) What are the qualifications of the persons who undertake the internal audit work?

(iii) To whom does the internal auditor report?

(iv) What are the areas covered by the internal audit?

(v) Has the internal auditor adequate technical assistance?

(vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work?

(vii) What is the follow-up?

12. (a) 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 transactions 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 the transaction on its

inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

(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.

(b) Extent of reliance on analytical procedures (SA 520) : The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices.

Alternatively, the auditor may consider whether the information was subjected to audit testing.

13. (a) Stock lying with third party

(i) Obtain confirmations from the third party including the time period and reasons thereof.

(ii) Evaluate condition of goods and see whether adequate provision has been made.

(iii) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.

(iv) Ensure that the goods have been included in the closing stock though lying with third party.

(b) Purchase of Motor Car

(i) Ascertain whether the purchase of car has been properly authenticated.

(ii) Check invoice of the car dealer to confirm purchase price.

(iii) Examine registration with Transport Authorities to verify the ownership.

(iv) Ensure that all expenses relating to purchase of car have been properly capitalized and the same have been disclosed properly in the balance sheet.

(c) 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 profit and loss account.

(iv) Compare the amount incurred in previous years with reference to total turnover.

(d) 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.

14. (a) Confirmation of Balances: Direct confirmation of balances from debtors/creditors in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor.

"Guidance Note on Audit of Debtors, Loans and Advances" issued by the ICAI recommends that the debtors may be requested to confirm the balance either:

As at the date of the balance sheet; or

As at any other selected date which is reasonably close to the date of the balance sheet.

The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially misstated.

Therefore, it is not necessary that balances of debtors/ creditors should necessarily be verified only at the end of the year only. In fact, in order to incorporate an element of surprise, the auditor may consider different confirmation dates periodically, i.e., Dec, 31 as a cut-off date in one year and June 30 in another year and so on. Therefore, the statement that balance confirmation from debtors/creditors can only be obtained for balances standing in their accounts at the year-end is not correct.

(b) Certificate from an Expert: The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of an expert. SA 620 on "Using the Work of an Expert", also states that an expert may be engaged / employed by the client. It further requires the auditor to assess skill, competence and objectivity of the expert amongst other factors and evaluate the work of an expert independently to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of SA 620 before relying upon the certificate obtained by the management from the actuary.

(c) Revaluation of Fixed Assets: The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS 10 on 'Accounting for Fixed Assets' requires that "an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution". Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

15. (a) As per AS 4, 'Contingencies and Events Occurring after the Balance Sheet Date', adjustments to assets and liabilities are required for events occurring after the balance sheet date if such event provides/relates to additional information to the conditions existing at the balance sheet date and is also materially affecting the valuation of assets and liabilities on the balance sheet date.

As per the information given in the question, the Trade receivable was already in a great financial difficulty at the time of closing of accounts. Bankruptcy of the Trade receivable in May 2013 is only an additional information to the condition existing on the balance sheet date. Also the effect of a Trade receivable becoming bankrupt is material as total amount of ₹ 8 lakhs will be a loss to the company. Therefore, the company is advised to provide for the entire amount of ₹ 8 lakhs in the books of account for the year ended 31st March, 2013.

(b) As per AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost and net realizable value.In this case, the cost of inventory is ₹ 10 lakhs. The net realizable value is 11,00,000 × 90% = ₹ 9,90,000. So, the stock should be valued at ₹ 9,90,000.

(c) The company should disclose the change in method of depreciation adopted for the accounting year. The impact on depreciation charge due to change in method must be quantified and reported by the enterprise.

Following aspects may be noted in this regard as per AS 6 on Depreciation Accounting.

(i) The depreciation method selected should be applied consistently from period to period.

(ii) A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.

(iii) When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed.

(iv) In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss.

(v) In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

16. (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) **Comment on Matters Contained under Section 227(1A) of the Companies Act, 1956:** Section 227(1A) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1A) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of T Ltd. is correct in non-reporting on the matters specified in Section 227(1A).

(c) 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 KRN & 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.

(d) 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.

(e) Disqualification of a Director under section 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 under section 274(g) of the Act, the auditor shall state in his report under section 227 about the disqualification of the particular director.

17. Power of Company to Purchase its Own Securities: The Companies (Amendment) Act, 1999 contains elaborate provisions enabling a company to buy-back its own securities. The work security includes both equity and preference shares. As per section 77A, a company may purchase its own shares or other specified securities ("buy-back") out of-

    (i) Its free reserves; or

    (ii) The securities premium account; or

    (iii) The proceeds of any earlier issue other than from issue of shares made specifically for buy-back purposes.

    No company shall purchase its own shares or other specified securities unless-

    (1) The buy-back is authorized by its Articles;

    (2) A special resolution has been passed in general meeting of the company authorizing the buy-back;

    (3) The buy-back is or less than twenty five per cent of the total paid-up capital (equity shares and preference shares) and free reserves of the company;

    (4) The debt equity ratio is not more than 2:1 after such buy back.

    (5) All the shares and other securities are fully paid up.

    (6) Every buy back shall be completed within 12 months from the date of passing the special resolution.

    (7) The company shall not make further issue of same kind of shares.

    The company, after buy-back file with the Registration and SEBI, a return containing such particulars relating to buy-back within 30 days.

    Requirements as per Revised Schedule VI: 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.

18. 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 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.

19. (a) **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 characterized 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.

(b) Audit of Local Bodies :

(i) The Local Fund Audit Wing of the State Govt. 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.

20. 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, 1956.

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

(a) to direct the manner in which the company's accounts shall be audited by the auditor, and to give the auditor instructions in regard to any matter relating to the performance of his functions; and

(b) to conduct a supplementary or test audit of the company's accounts by such person, as he may authorise in this behalf, and for the purposes of such audit to require information or additional information to be furnished to any person or persons, so authorised on such matters by such person or persons, and in such form as the CAG may direct.

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

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