PAPER – 6 : AUDITING AND ASSURANCE

QUESTIONS

Nature of Auditing

1. (a) Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2011-12. The closing stock of the company as on 31.3.2011 amounting to ₹ 200 lacs continued as it is and became closing stock as on 31.3.2012. The auditors of the company propose to exclude from their audit programme the audit of closing stock of ₹ 200 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. Comment.

   (b) State briefly the qualities of Auditors.

2. As an auditor, how would you deal with the following situation:

   (a) While Auditing the accounts of a APE Ltd, it comes to your information that the company is regularly maintaining an unduly large cash balance.

   (b) The management of XYZ Ltd. imposes a limitation on the scope of the auditor's work in the terms of a proposed audit engagement and the auditor is of the view that the limitation will result in the auditor disclaiming an opinion on the financial statements.

3. (a) Explain "Fraud risk factors" as discussed in SA 240.

   (b) "The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated." Explain.

Basic Concepts in Auditing

4. (a) "Independence is a state of mind and personal character and an enlightened view of the professional duties involved." Elaborate.

   (b) Explain the concept of "Materiality" as discussed in SA 320.

5. (a) What is an "Audit Evidence"?

   (b) What are the various methods of obtaining audit evidence?

6. (a) Explain with reference to the relevant Standard on Auditing, appropriateness of going concern assumption?

   (b) What is an "Accounting estimate"? Discuss the factors that may influence the degree of estimation uncertainty associated with an accounting estimate.

Preparation for an Audit

7. (a) What do you mean by Audit Documentation ("Working Papers")? State the purposes of Audit Documentation. Give at least five examples of Audit Documentation.

(b) The Auditor of TM Ltd requested the Management to provide written representations on the three matters but the management did not provide any written representation to the auditors. How should the auditor deal with this situation?

8. (a) What is the difference between Audit Procedure and Audit Techniques? Give at least five techniques commonly adopted by the auditors.

(b) RGS & Co. have been appointed as auditors to conduct audit of accounts of PAN Exports Ltd. for the year 2011-12. The auditors wanted to establish an overall strategy that would set the scope, timing and direction of the audit and also guide the development of the audit plan. Keeping in view the above, discuss the factors an auditor would take into consideration in establishing the overall strategy.

Internal Control

9. (a) State the factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit.

(b) What are the different design and procedural aspects of EDP systems?

10. (a) State the essential elements of a good system of Internal Check.

(b) What are the special steps involved in framing a system of Internal Check?

11. (a) What are the aims of internal control so far as Financial and Accounting aspects are concerned?

(b) Discuss the considerations an auditor would consider in exercising judgement as to which risks are significant risks giving special reference of SA 315.

Vouching & Verification of Assets and Liabilities

12. "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". Explain.

13. While conducting the audit of the accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply risen in comparison to the previous year. State the steps you would take to satisfy yourself.

14. State briefly how you will verify the following:

(a) Building

(b) Bank Balances

(c) Bills Payable

15. (a) Comment on the "Responsibility for properly determining the quantity and value of inventories rests with the management of the entity".

(b) No depreciation has been charged for the year ended 31st March 2012, in respect of a spare Bus purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year. State the duty of an auditor in this regard.

The Company Audit

16. As an auditor, comment on the following situation/statements:

    (a) RG & Co., chartered accountants were appointed as the auditors of a public limited company in their Annual General Meeting. Central Government and one State Government jointly held 51% of the paid-up share capital of the company.

    (b) The first auditors of H and W Ltd., a Government company, was appointed by the Board of Directors.

17. As an auditor, comment on the following situation/statements:

    (a) While conducting the audit of BVS Ltd. for the year ended 31st March, 2011, the auditor wanted to refer to the Provident Fund and ESI Records. The Board of Directors refused to show the aforementioned records to the auditor.

    (b) The auditor of ABC Ltd is unable to obtain sufficient appropriate audit evidence, and also he draws a conclusion that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

18. As an auditor, Comment on the following statements:

    (a) "Interest on share capital was paid to the shareholders as the company had a long gestation period before it could become operational".

    (b) "Credit for the profit arising out of a hire-purchase sale was fully adjusted in the year of sale".

19 State briefly, how you will audit the following in a joint stock company:

    (a) Issue of Sweat Equity Shares.

    (b) Shares Issued at a Premium.

Special Audits

20. M/s SGR & Associates have been appointed to audit the accounts of a Five Star Hotel in Delhi. What special steps will you as an auditor suggest to take into consideration in auditing the accounts of this hotel?

SUGGESTED ANSWERS / HINTS

1. (a) **Verification of Stocks** : SA 510 "Initial Audit Engagements – Opening Balances", requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

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

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

(iii) appropriate accounting policies are consistently applied.

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

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

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

The auditor should also have sufficient knowledge of general principles of law of contracts, partnership; specific statutes and provisions applicable, e.g. Companies Act, 1956, Co-operative Societies Act, etc.; client's nature of business and its peculiar features. Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities such as, tact; caution; firmness; good temper; judgement; patience; clear headedness and commonsense; reliability and trust, etc.

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

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

2. (a) If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash- on-hand, the auditor should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books.

If the cash-on-hand is not in agreement with the balance as shown in the books, the auditor should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report.

In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

(b) As per SA 210 "Agreeing the Terms of Audit Engagements", if management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

In the instant case, the management of XYZ Ltd. imposed the limitation on the scope of the auditor's work in the terms of a proposed audit engagement and the auditor is also of the view that the limitation will result in the auditor disclaiming an opinion on the financial statements. Hence, keeping in view the above, the auditor should not accept the engagement.

3. (a) As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud risk factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

(b) As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", professional skepticism may be defined as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Professional skepticism includes being alert to:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

4. (a) The Guidance Note issued by the ICAI on "Independence of Auditors" contemplates that it is not possible to define "Independence" precisely. According to it, independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self-interest. It stipulates that the independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly he himself is satisfied about his client and secondly, no unbiased person would be forced to the conclusion that on an objective assessment of the circumstances, there is likely to be an abridgment of the auditors' independence. There is also a collective aspect of independence that is important to the accounting profession as a whole.

Independence is a state of mind and personal character and an enlightened view of the professional duties involved. Independence is much affected by the state of the profession, *i.e.,* the ability and willingness to enforce a proper code of ethics as well as its ability to withstand pressures. The more the esteem for the profession in the public eyes because of the standards of independence prescribed by it for its members, greater the reliance there would be on the reports and opinions given by the members of the profession. Independence is a qualitative condition but rules are often framed by professional bodies to help and guide members in preserving independence in variety of complex circumstances. The chartered accountant is not personally known to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act, 1956 has enacted specific provisions to give concrete shape to this vital concept. The provisions disqualifying certain types of persons from undertaking audit of limited companies, provisions relating to ceiling on the number of audits that can be undertaken by chartered accountant, provisions requiring special resolution for appointing auditors in certain cases and other provisions on appointment, reappointment and removal of auditors are designed to invest this institution of audit with sufficient independence to carry out the audit in the larger interest of shareholders and other users. The vast powers of access given to the auditor to the books of account and other documents of the company are specifically designed to give independence to the auditors. The power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence. The enactment of specific instances of misconduct in the Schedules to the Chartered Accountants Act, 1949 is yet another attempt to keep the independence and professional competence of the accounting profession.

In order to ensure independence, the law has also made certain provisions which put either prohibitions or regulations in the matter of appointment of auditors –

Accordingly a person is disqualified to act as an auditor from being appointed as such if he is :

(i) an officer or employee of the company;

(ii) a partner or an employee of an officer or employee of the company; or

(iii) indebted to the company for a sum exceeding of ₹ 1,000.

(iv) a person holding any security (any financial instrument which carried voting rights) of that company after a period of one year from the date of the commencement of the Companies (Amendment) Act, 2000.

(b) Concept of Materiality*:* As per SA 320 “Materiality in Planning and Performing an Audit”, financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

  1. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred above provides the auditor with such a frame of reference.

2. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

   (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

   (b) Understand that financial statements are prepared, presented and audited to levels of materiality;

   (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

   (d) Make reasonable economic decisions on the basis of the information in the financial statements.

3. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

5. (a) **Audit Evidence:** As per SA 500 "Audit Evidence," information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

   (b) **Methods of Obtaining Audit Evidence:** The auditor obtains evidence by one or more of the following methods:

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

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

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

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

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

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

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

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

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

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

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

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

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.

- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

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

Other

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

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

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

(b) According to the SA 540, "Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures" 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.

The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

7. (a) As per SA 230 on "Audit Documentation", audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work-papers" are also sometimes used).

Purposes of Audit Documentation

Audit documentation provides:

(i) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(ii) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides the above mentioned purposes, Audit documentation also serves a number of additional purposes, including the following:

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

Examples of Audit Documentation

Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

- Audit programmes.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

(b) As per SA 580 "Written Representations", if management does not provide one or more of the requested written representations, the auditor shall:

(i) Discuss the matter with management;

(ii) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

8. (a) The two terms, procedure and techniques, are often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence. Basically audit procedures are broadly of two types viz. compliance procedures and tests of detail.

Test of details are further comprised of substantive audit procedures and analytical review procedures. Vouching is a substantive audit procedure which involves audit techniques like casting, cross-casting, checking of posting, etc. On the other hand, verification of assets and liabilities is a substantive audit procedure which involves application of audit techniques like physical examination, confirmation from third parties, etc.

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

(b) As per SA 300 "Planning an Audit of Financial Statements", 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 consider the undermentioned factors:

(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) The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon

the work of the internal auditor. As per SA 610 "Using the Work of Internal Auditors", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

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

Technical competence

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

Due professional care

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

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

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

the internal auditors when such matters may affect the work of the external auditor; and

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

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

(b) The different design and procedural aspects of EDP systems are:

(i) Consistency of Performance: EDP systems perform functions exactly as programmed and are potentially more reliable than manual systems, provided that all transaction type and conditions that could occur are anticipated and incorporated into the system.

(ii) Programmed Control Procedures: The nature of computer processing allows the design of internal control procedures in computer programs. These procedures can be designed to provide controls with limited visibility (e.g., protection of data against unauthorized access may be provided by passwords). Other procedures can be designed for use with manual intervention, such as review of reports printed for exception and error reporting, and reasonableness and limit checks of data.

(iii) Single Transaction Update of Multiple or Data Base Computer Files: A single input to the accounting system may automatically update all records associated with the transaction (e.g., shipment of goods documents may update the sales and customers' accounts receivable files as well as the inventory file). Thus, an erroneous entry in such a system may create errors in various financial accounts.

(iv) Systems Generated Transactions: Certain transactions may be initiated by the EDP system itself without the need for an input document. The authorization of such transactions may neither be supported by visible input documentation nor documented in the same way as transactions which are initiated outside the EDP system (e.g., interest may be calculated and charged automatically to customers' account balances on the basis of pre-authorized terms contained in a computer program).

(v) Vulnerability of Data and Programme Storage Media: Large volumes of data and the computer programs used to process such data may be stored on portable or fixed storage media, such as magnetic discs and tapes. These media are vulnerable to theft, or international or accidental destruction.

10. (a) Internal check has been defined by the Institute of Chartered Accountants of England and Wales as the "checks on day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned. A system of internal check in accounting implies organisation of system of book keeping and arrangement of staff duties in such a manner that no one person can completely carry through a transaction and record every aspect thereof.

    The essential elements of a goods system of internal check are:

    (i) Existence of checks on the day-to-day transaction.

    (ii) Which operate continuously as a part of the routine system.

    (iii) Whereby the work of each person is either proved independently or is made complementary to the work of another.

    (b) The following aspects should be considered in framing a system of internal check:

    (i) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.

    (ii) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

    (iii) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.

    (iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

    (v) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.

    (vi) The system of Budgetary Control should be introduced.

    (vii) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking and evaluation should be done by staff belonging to other than stock section.

    (viii) The financial and administrative powers should be sub divided very judicially and the effect of such division should be reviewed periodically.

(ix) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

11. (a) **Aims of Internal Control in relation to Financial and Accounting Aspects:** Internal controls relating to financial and accounting aspects are concerned with achieving the following objectives –

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

(ii) all transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(iii) assets and records 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.

Thus, it is clear from the above that internal controls relating to accounting and financial aspects primarily aim at providing the flow of work through various stages so as to segregate the authorising, recording and custodial aspects of the transaction.

For example, in a transaction involving purchase of fixed assets, the Board may authorise the Purchase Manager to purchase fixed assets, the recording of the purchase is performed by the Accounts Department, while the custody of assets rests with User Department. At the authorisation stage, the internal controls aim at ensuring that transactions are executed in accordance with the management's authorisation, general or specific. Thus, it ensures compliance with prescribed policies and procedures.

The internal controls at the recording stage, in particular, aim at ensuring that no single person can handle a transaction from the beginning to the end. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains knowledge of the design of the accounting and internal control systems, and their operation.

For example, an auditor may perform a "walk-through" test that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things.

- The size and complexity of the entity and of its information system.
- Materiality considerations.
- The type of internal controls involved.
- The nature of the entity's documentation of specific internal controls.
- The auditor's assessment of inherent risk.

(b) As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", significant risk may be defined as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

(i) Whether the risk is a risk of fraud;

(ii) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;

(iii) The complexity of transactions;

(iv) Whether the risk involves significant transactions with related parties;

(v) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

12. 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 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.

13. There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that of the previous year; the most likely causes are as under:

(i) *Increase in Sales Prices:* The selling price of the finished products may have been increased. Enquiries should be made by auditor as to whether there have been general or specific price increase and the reasons for the same. The auditor should obtain copies of the company price lists prevailing at different point of time and make the relevant comparison.

(ii) *Reduction in Cost of Manufacturing:* The cost of manufacturing may have reduced substantially. The auditor should examine the stock and purchases records in respect of large purchases of raw materials, comparing current costs with those in the previous year and detailed information supporting the possibility should be sought from the company.

(iii) *Alteration in Sales-mix:* The mix of sales may have been altered, resulting in the sales of more profitable items. Detailed sales analysis should be made for the period in order to ascertain whether the more profitable lines constituted a large proportion of the total sales.

(iv) *Impact of Automation*: The mechanisation or automation of certain manufacturing processes may have resulted in considerable saving in labour cost and this possibility could be easily verified by comparisons of wages records.

(v) *Adherence to Cut-off Procedures:* The company cut-off procedures as regards closing stock and work-in-progress should be investigated, as any change in the procedure as compared with the previous year would cause a difference in the gross profit ratio. It should also be seen that the procedure laid down has been observed by the concerned personnel and rightly adhered to. The auditor should test relevant transaction and ensure that everything is incorporated in the financial statement.

(vi) *Manipulating Sales*: The possibility of items which have been sent to customers on 'sale or return' basis being included in sales should be investigated, as this would give effect for increase in the rate of gross profit.

14 (a) Building:

(i) Verify the cost by reference to the architect's certificate as well as the contractor's receipts for amounts paid in case building is completed during the year. If the building has been constructed by the client's own organisation, it will be necessary for the auditor to verify that the basis upon which cost of materials, wages and the supervision charges have been allocated to the account and same are reasonable.

(ii) Check whether depreciation has been provided on a consistent basis.

(iii) Confirm the existence of building either through physical observation or other documentary evidence.

(iv) Check the title deeds and verify that building is owned by the entity.

(v) Ascertain whether any charge has been created on the building. If so, the same has been disclosed.

(vi) Examine lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc.

Also ensure that all covenants in the lease deed have been fulfilled by the client.

(vii) If revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made.

(viii) In case of a company, ensure that buildings under lease have been separately disclosed as per the requirements of Revised Schedule VI (applicable from 1.4.2011) to the Companies Act, 1956.

(b) Bank Balances:

(i) Verify bank balance by reference to bank statements.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment/write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) With effect from financial year 2011-2012, under the requirements of Revised Schedule VI (applicable from 1.4.2011) to the Companies Act, 1956, the presentation and disclosure requirements should be complied with.

(c) Bills Payable: These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed. Steps involved in their verification are:

(i) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.

(ii) Trace all the entries in the Bills Payable Book to the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.

(iii) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.

(iv) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.

(v) Verify that the charge, if any, created on any asset for the due payment of bills has been appropriately disclosed.

15. (a) 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 of

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.

As per SA 501 on "Audit Evidence: Additional Considerations", the following principles are laid down by ICAI:

(i) When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable, due to factors such as the nature and location of the inventory, so that the auditor could observe the compliance of management's procedures in this regard;

(ii) If he is unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded;

(iii) Where attendance at the physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation;

(iv) When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement and the assessment of inherent and control risk at different locations;

(v) The auditor would review management's instructions regarding:

- application of control procedures, for example, collection of used stock sheets, accounting for unused stock-sheets, tagging and count and recount procedures;
- identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, inventory owned by a third party, and
- arrangements made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off date.

(vi) The auditor would also consider cut-off procedures including details of the movement of inventory just prior to, during and after the count to ensure that such movements are appropriately included and/or excluded, as applicable from such inventory. For example, (a) goods purchased but not received are included in the inventories; and (b) goods sold but not despatched are excluded from the inventories;

(vii) For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when the control risk is assessed at less than high. The auditor would assess whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded;

(viii) The auditor performs audit procedures over the final inventory listing to assess whether it accurately reflects actual inventory counts;

(ix) When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party/ arrange with the entity for sending requests for such confirmation as to the quantities and condition of inventory held on behalf of the entity. Further, depending on materiality of this inventory the auditor would also consider the following:

- the conduct of the third party in the past with the entity and independence of the third party;
- observing, or arranging for another auditor to observe, the physical inventory count;
- obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that the inventory is correctly counted and adequately safeguarded;
- inspecting documentation regarding inventory held by third parties;
- subsequent receipt of goods from third parties.

(x) The auditor should obtain a written representation from management concerning (a) the completeness of information provided regarding the inventory; and (b) assurance with regard to adherence to laid down procedures for physical inventory count;

Audit Conclusions and Reporting: If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count the auditor should make a reference to a scope limitation in his audit report. If the inventory is not disclosed appropriately in the financial statements, the auditor shall modify the opinion in the auditor's report in an appropriate manner.

(b) As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes.

Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets.

In the instant case, no depreciation has been charged for the year on a spare bus, which was purchased during the year and kept ready by the company for its use as a stand-by, but was not used during the year is not correct. As when the spare bus was kept ready for use as stand-by, it means it was intended to be used for the purpose of business.

Therefore, depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31st March, 2012. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

16. (a) Appointment of Auditors: The implication of shareholding of 51% of paid-up capital by the Central Govt and State Govt is two fold as discussed below:

In terms of Section 224A of the Companies Act, 1956, a company in which not less than 25% of the subscribed share capital is held, whether singly or in any combination, by:

(i) a public financial institution or a Government company or the Central Government or any state government; or

(ii) any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of subscribed share capital; or

(iii) a nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment of an auditor in the Annual General Meeting shall be made only by passing a special resolution.

In this case, RG & Co. were appointed as auditors of the public limited company where 51% of the paid-up share capital was held by the Central and State Govt. Passing a special resolution was necessary. Hence, the appointment of RG & Co., chartered accountants, was null and void.

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

Accordingly, the provisions of Section 619 will apply in this case.

(b) **Appointment of the First Auditor by the Board of Directors:** Section 224(5) of the Companies Act, 1956 (the Act) lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company". Thus, the first auditor of a company can be appointed by the Board of Directors within one month from the date of registration of the company. However, in the case of a Government Company, the appointment or re-appointment of auditor is governed by the provisions of Section 619 of the Companies Act, 1956. Hence in the case of M/s H and W Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.

Thus, the appointment of first auditors made by the Board of Directors of M/s H and W Ltd., is null and void.

17\. (a) Section 227 of the Companies Act, 1956 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit.

In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the statutory records maintained by the company.

It is, therefore, essential for the auditor to refer to the Provident Fund and ESI records. In the absence of such records, the auditor may not be able to vouch/verify certain transactions of the company.

In case the directors have refused to produce the above mentioned records for auditor's verification, the auditor may consider extending the audit procedure as also shall modify the opinion in the auditor's report in an appropriate manner.

(b) As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", the auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In other words, if the auditor is not able to obtain sufficient appropriate audit evidence and arrives at a conclusion that undetected misstatements would have material and pervasive effects on the financial statements, then the auditor shall issue a disclaimer of opinion.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Keeping in view the above, the auditor should issue a disclaimer of opinion in the case of ABC Ltd.

18. (a) Payment of interest out of capital: Section 208 of the Companies Act, 1956 permits payment of interest to shareholders out of capital, where there is a long gestation period. Payment of interest on capital is, however, capitalised as part of cost of construction of the project. The auditor should ensure that following conditions have been complied whenever such interest has been paid:

(i) Payment is authorised by the Articles or by special resolution of shareholders in general meeting;

(ii) Payment is approved by the Central Government;

(iii) It is paid only for the period determined by the Central Government not exceeding six months after the half-year in which the project has been completed.

(iv) The rate shall not exceed 12% p.a. or such other rate as may be prescribed by the Government.

(v) The payment of interest shall not operate as a reduction of the amount paid-up on the shares in respect of which it is paid.

(b) The nature of a hire-purchase transaction makes it absolutely clear that a person does not become owner till the last instalment has been paid. As per AS 9 on "Revenue Recognition", credit for the amount of profit arising from hire purchase sales is not taken into account until the instalments of sales price have been realised. Therefore it is distributed proportionately over the hire purchase period.

Accordingly, in the instance case, credit for the amount of profit arising from hire purchase sale is not to be taken into account until the last instalment of sales price have been realised.

Further, it is not proper to take the entire difference between the total hire purchase consideration and the cash value of the relevant asset to the profit and loss account at the time of delivery of goods. Instead this difference is recognised in various accounting periods proportionately on the basis of hire purchase consideration outstanding during the accounting period.

Accordingly, in cases where profit arising on a hire purchase sale has been adjusted fully in the year of sale, a provision equal to the amount of profit which has not accrued should be created. The amount of provision so made should also be deducted from the "hire purchase debtors" for purposes of disclosure in the balance sheet.

19. (a) **Issue of Sweat Equity Shares:** The Companies (Amendment) Act, 1999 recognised that in the wake of globalisation of corporate sector, the employees will have to be rewarded suitably to share in the growth of company. By insertion of section 79A, the employees may be compensated in the form of "sweat equity shares". As per explanation to section 79A, the expression "sweat equity shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the sweat equity shares issued by the company are of a class of shares already issued and following conditions are fulfilled:

(i) The issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;

(ii) The resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(iii) Not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business;

(iv) The sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities Exchange Board of India in this behalf:

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

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

(b) Shares Issued at a Premium: Where a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, Section 78 prescribes that a sum equal to the amount of the premium collected should be transferred to the Securities Premium Account. Since the Act provides that the amount of premium will be considered a part of the share capital and that the amount of premium collected on shares can only be reduced in the manner prescribed for the reduction of capital, the amount of share premium received cannot be forfeited when the shares in respect thereof are forfeited. The auditor should also see compliance with SEBI Guidelines.

20. The business of running a hotel is very much dissimilar to running an industrial unit for manufacturing of products. It is a service-oriented industry. The business is characterized by handling of large amounts of liquid cash, stock of foods providing a variety of services, and keeping watch on customers to ensure that they do not leave hotel without settling the dues. In view of these, the following matters require special attention by the auditor.

(i) *Internal Control:* Pilferage is one of the greatest problems in any hotel and it is extremely important to have a proper internal control to minimize the leakage. The following points should be checked:

(a) Effectiveness of arrangement regarding receipts and disbursements of cash.

(b) Procedure for purchase and stocking of various commodities and provisions.

(c) Procedure regarding billing of the customers in respect of room service, telephone, laundry, etc.

(d) System regarding recording and physical custody of edibles, wines, cigarettes, crockery and cutlery, linen, furniture, carpets, etc.

(e) Ensure that the trading accounts are prepared preferably weekly, for each sales point. A scrutiny of the percentage of profit should be made, and any deviation from the norms is to be investigated.

(ii) Room Sales and Cash Collections

(a) There are various sales points scattered in a hotel and sales are both for cash and credit. The control over cash is very important. The charge for room sales is made from the guest register, and tests are to be carried out to ensure that the correct numbers of guests are charged for the exact period of stay. Any difference between the rate charged to the guests and standard room rent is to be investigated to see that it is properly authorized.

(b) The total sales reported with the total bills issued at each sales point have to be reconciled.

(c) Special care must be taken in respect of bills issued to customers who are staying in the hotel, because they may not be required to pay the bills immediately in cash but at a future date or by credit cards. Billing is to be done room-wise. It must be ensured that all customers pay their bills on leaving the hotel or within specified dates.

(iii) *Stock:* The stocks in a hotel are all saleable item like food and beverages. Therefore, following may be noted in this regard:

(a) All movement and transfer of stocks must be properly documented.

(b) Areas where stocks are kept must be kept locked and the key retained by the departmental manager.

(c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(d) Many hotels use specialized professional valuers to count and value the stocks on a continuous basis throughout the year.

(e) The auditor should ensure that all stocks are valued at the year end and that he should himself be present at the year end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories

(iv) *Fixed Assets:* The fixed assets should be properly depreciated, and the Fixed Assets Register should be updated.

(v) *Casual Labour*: In case the hotel employs the casual labour, the auditor should consider, whether adequate records have been maintained in this respect and there is no manipulation taking place. The wages payment of the casual labour must also be checked thoroughly.

(vi) The compliance with all statutory provisions, and compliance with the Foreign Exchange Regulations must also be verified by the auditor, especially because hotels offer facility of conversion of foreign exchange to rupees.

(vii) Other special aspects are to be verified as under

(a) Consumption shown in various physical stock accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.

(b) All payments to the foreign collaborator, if any, are to be checked.

(c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.

(d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, boutiques, and special shows should be verified with the arrangements made.

(e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.

(f) The occupancy rate should be worked out, and compared with other similar hotels, and with previous year. Material deviations should be investigated.

(g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.

(h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.

(i) Apart from control over stock of edibles, control over issue and physical stock of linen crockery, cutlery, glassware, silver, toilet items, etc. should be verified.

(j) The auditor should verify the restaurant bills with reference to KOT (Kitchen order Ticket).

(k) The auditor should ensure that all taxes have been included in the client's bills.

(l) Computation and payment of salaries and wages vis-a-vis number of employees must be checked.