PAPER – 6 : AUDITING AND ASSURANCE

QUESTIONS

Nature of Auditing

1. (a) Briefly explain the classification of Auditors on the basis of functional division.

   (b) In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment".

2. (a) 'After the statutory audit has been completed a fraud has been detected at the office of the auditee.' What is your defence as an auditor?

   (b) IT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, have also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. Comment.

Basic Concepts in Auditing

3. The new audit trainee of XYZ Ltd. has been provided with the following list of the Audit Procedures:

   (i) Counted cash on hand

   (ii) Asked the client questions about internal controls

   (iii) Received letter from client's attorney stating attorney was not aware of any lawsuits

   (iv) Computed gross margin and compared to prior years

   (v) Examined sales document to support sales journal entry

   (vi) Reviewed next year's invoices to see, if any, invoices that related to current year expenses were paid but not recorded

   (vii) Stood beside mailroom clerk to determine whether clerk listed all cash receipts in incoming mails

   (viii) Supported repairs expense by examining invoices

   (ix) Compared utilities expense by examining invoices

   (x) Received letter from a public warehouse verifying that company had goods stored in the warehouse

   (xi) Examined equipment purchased during the year

   (xii) Compared bad debts expense to credit sales

   (xiii) Added sales journal column to see if totals were correct

(xiv) Examined minutes of board of directors to support payment of dividends

(xv) Discussed with credit manager collectability of accounts receivable

Required

Classify each audit procedure as one of the following sources or type of evidence

(a) Physical evidence

(b) Representation by third parties

(c) Mathematical evidence

(d) Documentation

(e) Representation by client personnel

(f) Data interrelationships

4. ABC & Co. and DEF & Co, Chartered Accountant firms were appointed as joint auditors of Good Health Care Ltd. for 2009-10. A special audit was conducted undersection 233A of the Companies Act 1956 during March 2011 and observed gross understatement of Revenue. The revenue aspects were looked after by DEF & Co, but there was no documentation for the division of work between the joint auditors.

Preparation for an Audit

5. An Auditor must take care to ensure that nothing is missed in the process which needs to be followed to achieve the audit objective. Explain the audit process with the help of a specimen.

6. (a) How does an audit programme help to plan and perform the audit?

   (b) Draft an audit programme to audit the receipts of a cinema theatre owned by a partnership firm.

Internal Control

7. (a) You are the Chief of the Internal Audit Department of a large manufacturing concern. As the head of the department your duty inter alia is to advise on and observe the maintenance of proper records of plants, machinery, tools and dies as well as to keep a watch upon the chances of obsolescence of the plants and machineries. Draft suitable programme by which you can discharge your duties properly.

   (b) In spite of the internal control weakness commented upon by the audit manager, no further tests need to be carried out, as the purchase and sales figure as a percentage of gross profit was same as in the previous year. The audit manager's comments were in regard to control over purchases and sales.

8. (a) What are the points to be kept in mind regarding the evaluation of internal control over after sales service?

(b) Design an Internal control system for one of the core functional area, “Treasury”.

Vouching

9. How will you vouch and/or verify the following?
   (a) Research and Development expenses
   (b) Recovery of Bad Debts written off
   (c) Goods sent out on Sale or Return Basis
   (d) Borrowing from Banks

10. (a) What do you understand by the expression ‘cut-off’ procedure? Mention some of the points with which you as an auditor would be concerned.
    (b) Mention seven special matters which you would verify in the course of audit of the following:
    (1) Expenditure for Advertisement in News paper.
    (2) Building contractor.

Verification

11. State briefly the duty of an auditor with regard to each of the following:
    (a) A sum of ₹ 10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing ₹ 8,00,000. The amount is credited to the Purchases Account.
    (b) Cost of structural alterations amounting to ₹ 60,000 to self-owned factory premises has been charged to Building Repairs.

12. As an auditor, comment on the following situations/statements:
    (a) HS Ltd. Purchased a factory building for ₹ 2 crores at Manesar. The company paid ₹ 2 lakhs professional fees to its solicitors for providing consultancy in connection with purchase of factory. The accountant debited ₹ 2 lakhs as legal expenses in the account books of the company.
    (b) During the year 2011-12, a company has developed blocks and dies for ₹ 30 Lakhs. The company did not provide any depreciation on the said blocks and dies. State the auditor’s duties.

The Company Audit

13. The Chairman of System International Limited, a large trading company with extensive overseas interests, has asked you to accept the nomination to replace the present auditors at the next annual general meeting of the company.

Before acceptance of any new audit assignment, there are a number of reasons for non-acceptance that have to be considered. List the circumstances in which acceptance of the nomination would be inappropriate under the following:

(1) Legal aspect

(2) Ethical aspect

(3) Practical aspect

14. (a) State your views on the following request made by the management of X Ltd.:"The branch accounts were audited by another firm of Chartered Accountants and, therefore, they could rely on the same and only check the consolidation".

(b) M/s S & Co., has been the company auditor for Amu Company Limited for the year 2011-12. The company had three branches located at Chennai, Delhi and Mumbai. The audits of branches-Chennai, Delhi were looked after by the company auditors themselves. The audit of Mumbai branch had been done by another auditor M/s V & Co., a local auditor situated at Mumbai. The branch auditor has completed the audit and had given his report too. After this, but before finalization, the company auditor wanted to visit the Mumbai branch and have access to the inventory records maintained at the branch. The management objects to this on the ground that the company auditor is transgressing the scope of audit areas agreed.

Company Audit –II

15 (a) XYZ (Pvt.) Ltd. has paid up Capital and Reserves of ₹ 60 lacs and secured Loans of Nationalized Banks having sanctioned limit of ₹ 28 lacs and outstanding balance of ₹ 23 lacs. The turnover of the company is ₹ 5.10 crores for the year ended 31.3.2012. A customer returns goods worth 40 lacs on 2.4.2012, out of sales made during the year ended 31.3.2012. The management of the Company is of the opinion that CARO, 2003 is not applicable to the company.

(b) State briefly, how you will audit the following in a joint stock company:

(1) Issue of shares for consideration other than cash.

(2) Buy-back of shares by the company.

(3) Splitting of one share of the face value of ₹ 100 into 10 shares of ₹ 10 each.

16. Comment on the following:

(a) M/s Bony Ltd has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2011-12 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2010-11 was less charged by ₹ 35 lacs on account of arithmetical error on the part of Insurance Company. M/s Bony Ltd. paid the said sum of ₹ 35 lacs during the accounting year 2011-12 by debiting the same to Prior Period Expenses.

(b) Directors of Speedy Ltd declared a final dividend of 30% for 2011-12 in their meeting held on 11-8-2012.

Special Audits

17. (a) An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

(b) M/s. XYZ, a partnership firm, approaches you and enquires, whether it is necessary for them, under any statute or otherwise, to get their accounts audited. You are required to advise them, explaining briefly the advantages of audit of a partnership firm.

18. (a) With reference to Government Audit, what do you understand by “Audit of Commercial Accounts”?

(b) How the audit is advantageous to Sole Trader?

Standards on Auditing and Guidance Notes

19. State your views on the following requests made by the management of X ltd.

(a) The teeming and lading fraud was detected and the amount involved was detected and the amount involved was subsequently deposited by the Executive Director of the company and, therefore, need not be reported upon.

(b) “Auditor’s assessment of materiality may be different at the time of planning the engagement than at the time of evaluating the results of his audit procedures”. Discuss.

20. Write short notes on the following:

(a) Financial indications to be considered for evaluating the assumption of going concern

(b) Auditor's responsibilities regarding comparatives.

(c) Sampling Risk

(d) Reporting on a compilation engagements

SUGGESTED ANSWERS / HINTS

1 (a) **Functional Basis – Classification of Auditors**: On the basis of functional division, auditors can be classified in two broad categories, namely, external auditors and internal auditors. External auditors are the persons who practise the profession of accountancy having qualified in the professional examination and are external *vis-a-vis* the organisation of which they audit the accounts. The internal auditors, on the other hand, may also be professionally qualified and are internal *vis-a-vis* the organisation in which they are appointed to perform specific work. They are considered internal because their appointment is done by the management and the scope of work is also specified by it. They may be appointed either on a contract basis or as employees to undertake auditing of the books and records as a part of management control and appraisal system. The external auditors, on the other hand, are appointed by the owners of the organisation, say, shareholders of the company and thus they are treated external to the organisation in which they have been appointed. When an external auditor is appointed under a particular statute, such auditor may be known as the statutory auditor. Their scope of work is determined by the statute under which they have been appointed. Another significant distinction between the internal and external auditor is that the former is not considered independent *vis-a-vis* the management of the organisation while the latter is independent of the management of the organisation which is responsible for the preparation of the books of account. Finally the scope of work of an internal auditor may extend even beyond the financial accounting and may include cost investigation, inquiries relating to losses and wastages, production audit, performance audit, etc. It must be remembered that the basic foundation of any type of auditing, whether internal or external, envisages that the auditor must be independent of the activity for which he is going to conduct an audit. Even though the internal auditor is an employee yet he must be independent to the extent practicable.

(b) **Obtaining Knowledge of the business :** The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

As per SA 315 – "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", The auditor shall obtain an understanding of the following:

(i) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

(ii) The nature of the entity, including:

(1) its operations;

(2) its ownership and governance structures;

(3) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(4) the way that the entity is structured and how it is financed;

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(iii) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(iv) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(v) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

2. (a) As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Such a system reduces but does not eliminate the possibility of fraud and error. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. The risk of not detecting a material misstatements resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance

of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures. The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus, in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.

(b) As per SA 570 on "going concern", when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. The auditor should evaluate the risk that the going concern assumption may no longer be appropriate. If in the auditor's judgement, the going concern is not satisfactory resolved, he should consider various appropriate options.

To judge and evaluate the continuance as a going concern, he should evaluate and gather indications from financial, operating and other resources.

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

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

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

3. The classification of the Audit Procedures on the basis of Sources or Types of Evidence is as follows

(a) Physical evidence:

(i) Counted cash on hand

(vii) Stood beside mailroom clerk to determine whether clerk listed all cash receipts in incoming mails

(xi) Examined equipment purchased during the year

(b) Representation by third parties:

(iii) Received letter from client's attorney stating attorney was not aware of any lawsuits

(c) Mathematical evidence:

(xiii) Added sales journal column to see if totals were correct

(d) Documentation:

(v) Examined sales document to support sales journal entry

(viii) Supported repairs expense by examining invoices

(ix) Compared utilities expense by examining invoices

(x) Received letter from a public warehouse verifying that company had goods stored in the warehouse

(xiv) Examined minutes of board of directors to support payment of dividends

(e) Representation by client personnel:

(ii) Asked the client questions about internal controls

(xv) Discussed with credit manager collectability of accounts receivable

(f) Data interrelationships:

(iv) Computed gross margin and compared to prior years

(vi) Reviewed next year's invoices to see, if any, invoices that related to current year expenses were paid but not recorded

(xii) Compared bad debts expense to credit sales

4. **Documentation for Division of Work between the Joint Auditors:** As per SA 299 "Responsibility of Joint Auditors", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas.

In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would not be divided and would be covered by all the joint auditors.

The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Further, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

In the present case, there was no documentation for the division of work and the responsibility of revenue aspect was delegated to DEF & Co., in which gross understatement of revenue has been observed. ABC & Co. has not reviewed the work as they have put their reliance on the work performed by DEF & Co.

Hence, there is a violation of SA 299 as the division of work has not been documented. In the normal course DEF & Co. will be held liable for negligence. If DEF & Co. refuses to accept sole responsibility for the fault, ABC & Co. have to prove by other ways and means of evidences that the particular area of audit was exclusively done by DEF & Co. only.

5. Audit process to ensure achievement of the Audit Objective

The following audit process may be taken as a specimen to ensure that nothing is missed in the process which needs to be followed to achieve the audit objective:

(a) Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.

(b) Examination and evaluation of the nature, extent and efficacy of the system of internal control. The nature, extent and timing of substantive procedures, would depend upon the extent of satisfaction an auditor obtains after evaluating the internal control system. The determination of extent of test checking would also depend upon the same.

(c) Ascertaining the arithmetical accuracy of the books of account by checking posting, casting, cross-casting, carry forwards, opening and closing balances, etc.

(d) Examining the documentary evidence (both internal and external) and the authority in support of the transaction, i.e. vouching.

(e) Checking the validity of transactions with reference to:

   (i) provisions affecting the accounts and audit in any Act or Rules;

   (ii) rules and regulations governing the constitution and management of the organisation i.e., the memorandum and articles of association in the case of a company, partnership deed in the case of a firm, trust deed in the case of a trust and bye-laws in the case of a co-operative society;

   (iii) minute book for appropriate sanction of the transactions by competent authority;

   (iv) other legal documents such as the prospectus, returns submitted to legal authorities, contracts and agreements *e.g.*, vendors' agreement, lease agreement, selling agency agreement, collaboration agreements, etc; and

(v) well recognised accounting principles and practices *e.g.*, distinction between capital and revenue, accrual system of accounting, valuation principles, etc.,

(f) Ensuring that there is adequate disclosure of information and, in particular, the annual accounts are prepared in such a manner as to convey the real picture about the assets and liabilities and of the operating result (profit or loss) of the organisation. For this purpose, the auditor must conform to the prescribed legal requirement, if any, as to the form of accounts and have due regard to the best current accounting practice. Reference to Revised Schedule VI in case of companies and compliance with accounting standards will have to be seen.

(g) Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.

(h) Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.

(i) Application of various overall checks in order to test the overall reliability of the accounting records and the statements and to see whether the results of overall checks corroborate the findings already made.

(j) Determination of the significant accounting ratios and subjecting the accounts to ratio analysis, to locate the areas, showing departure from the expected state of affairs.

6. (a) The role of audit programme in audit plan and performance: The audit programme is helpful both in planning and performance stages of audit:

(1) The audit programme lists down areas of audit before commencement.

(2) The audit timing is built therein; thereby it becomes a schedule of audit plan.

(3) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.

(4) It specifies the procedures to be checked during the audit.

(5) As the audit work is split into various elements of procedures to be performed, the audit programme acts as a guiding chart or check list during the performance of audit.

(6) Since the staff in charge of each work is specified and they sign the programme, it extracts the responsibility from the audit assistants.

(7) The working papers of the audit staff can be reviewed against the audit programme which helps a base of reference for evaluation of the performance before reporting on the financial statements.

(8) It also helps in preparing a diary of the performance and plan and also base for billing the clients for the time and manpower involved in the audit.

(b) **Programme for receipts of cinema theatre of a firm:** Audit programme for checking the receipts of a cinema theatre of a partnership firm.

(1) The partnership deed should be first scrutinized.

(2) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.

(3) The internal control for collections from sale of tickets should be checked.

(4) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.

(5) Check the rough cash book and reconcile from the stock of ticket books issued, the cash to be collected each day.

(6) Check that the cash balance and ticket sales from stock is daily checked by the manager.

(7) Check that the collections are banked daily, the very next day.

(8) See rates for each class and the ticket rates are as per current prices.

(9) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.

(10) Check the relation between the amounts of tax collected and sales.

(11) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.

(12) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.

(13) The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.

(14) Do surprise checking of cash balances.

(15) See that cash collections are insured and the policy is in force.

7. (a) **Audit Programme for the Internal Audit Department:** The audit programme to be followed by the Internal Audit Department in proper discharge of duties is set out below:

(i) Records of plant, machinery, etc. clearly show the date of purchase of assets, cost price, location, depreciation charged, etc. and see that physical verification has been conducted at frequent intervals.

(ii) Log books regarding maintenance of the assets have been maintained properly.

(iii) Maintenance of movement register for movable equipments should be verified and see that recording has been done properly.

(iv) See that each item of plant and machinery has been given a distinct code number to facilitate identification. The maintenance of a code register should also be verified.

(v) Verification should be made of sales, disposal, retirement, etc. of these assets by reference to authorisation, sales memos or other appropriate documents.

(vi) Maintenance of a complete list of tools, spare parts for each plant and machinery should be examined.

(vii) To check on obsolescence it should be seen that opinion from experts have been taken from time to time to ensure purchase of technically most useful, efficiently and advanced machines after a thorough study.

(viii) It should be reviewed whether assets have been disposed off after a proper technical and financial advice.

(ix) Reporting costs relating to each plant and machinery should be reviewed.

(x) Research and development activity should be reviewed, to ascertain extent of its relevance to the operations of the organisation and contribution towards maintenance of machinery efficiency and preventing early obsolescence.

(xi) Programme for an actual periodical servicing and overhauling of machine, etc. should be scrutinised.

(b) Performing Appropriate Audit Procedures Due to Weaknesses in Internal Control System: The audit manager's observation that internal control over purchases and sales were weak after evaluating the system should be quite pertinent for the auditor.

However, the auditor's judgement that no further tests need to be carried out since purchase and sale as a percentage of gross profit were same as in the previous year cannot be accepted since the same percentage may be a coincidence.

As a matter of fact, while performing analytical procedures when no deviations are reported, it is necessary to investigate such a situation in more detailed manner to ascertain the reasons for same percentage. It is quite possible that the absolute figures might have changed in the same proportion. In fact, such a state of affairs calls for conducting further audit tests in detail since there might have been attempts by the management to manipulate figures.

Therefore, the audit team would have to rely more on test of details of transactions and balances than on drawing their conclusions on analytical procedures.

In fact, the auditor should carry out substantive tests in more detail to ensure that transactions are genuine and valid and, thus, supported by sufficient and appropriate evidence.

8 (a). Evaluation of internal control over after sales service

i. Nature of after sales services rendered by the enterprise.

ii. Maintenance of adequate records such as customer cards of after sales services provided to each customer indicating the period and other details.

iii. Manner of distinction should be made between the customers being serviced under warranty period and those under the annual maintenance contract.

iv. Type of a form describing date wise the services rendered or parts replaced on each visit by service engineers.

v. Manner of collecting service charges on annual basis or on periodic visits from customers who are not covered by annual maintenance contract by service engineers and issue provisional receipts to customers in the case of changeable parts.

vi. Existence of any system of reconciliation of stores and spare parts issued with the cash received.

(b) Internal control system for Treasury

Coverage

This covers cash, bank, and investments transactions.

System

i. There should be a separate mail department which is a responsible for opening and distribution of incoming mail.

ii. All the incoming cheques and drafts should be crossed A/c payee.

iii. The cashier should not be made responsible for the preparation of receipts.

iv. The cheques and drafts should be handed over to another assistant who is responsible for the preparation of pay in slips and deposit the same for collection into the bank.

v. Receipts should be pre numbered and such number shall be cross referred in the cash book.

vi. The unused receipt book shall be kept under lock.

vii. The receipts should be authorised by responsible official.

viii. All the cash payments should be made against the printed vouchers, which are pre numbered.

ix. If petty cash book is maintained, proper control should be exercised over the petty cashier.

x. Where payments are made to supplier by cheque, the statement of account should be referred to by the approving authorities.

xi. All the cheques issued should be crossed A/c payee.

xii. The authority for signing the cheques should be specified clearly by the management.

xiii. A senior executive shall carryout surprise cash check at periodic intervals.

xiv. A limit shall be fixed with regard to the balance of cash which can be held by the entity.

xv. There should be insurance policies covering the cash chest and the fidelity of the cashier.

xvi. Periodic Bank recollection Statement should be prepared by a person who is not connected with the bank transactions.

xvii. The unused cheque leaves should be kept under safe custody of a responsible officer.

9. (a) Research and Development Expenses

(i) Ascertain the nature of research and development work at the outset and enquire whether separate Research and Development Department exists.

(ii) See allocation of expenses under revenue and deferred revenue. Ensure that expenses which are routine development expenses are charged to Profit and Loss Account.

(iii) Check whether the concerned research activity is authorised by the Board and has relevance to the objectives of the company.

(iv) Examine that generally research expenses for developing products or for inventing a new product are treated as deferred revenue expenditure to be written off over a period of three to five years, if successful. In case it is established that the research effort is not going to succeed, the entire expenses incurred should be written off to the profit and loss account.

(v) Ensure that if any machinery and equipment have been bought specially for the purpose of research activity, the cost thereof, less the residual value should be appropriately debited to the Research and Development Account over the years of research.

(b) Recovery of Bad Debts written off

(i) Ascertain the total amount of bad debts.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(c) Goods sent out on sale or return basis

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) See that price of such goods is unloaded from the sales account and the debtor's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.

(iv) Confirm that the stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing stock.

(d) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

(i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

(v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

10. (a) Cut-off procedure: Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separate from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for the purpose is technically known as "Cut-off arrangement". It essentially forms part of the internal check of the organisation. Accounts, other than sales, purchases and stock are not usually affected by the continuity of the business and, therefore, this arrangement is generally applied only to the aforesaid accounts. The auditor satisfies by examination and test checks that the cut-off procedures adequately ensure that:

(i) goods purchased, property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase; and

(ii) goods sold have been excluded from the inventories and credit has been taken for the sales; if the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and after the cut off date and check whether stocks represented by those documents were included or excluded as appropriate during stock taking.

(b) (1) Expenditure for Advertisement in News paper

(i) Vouch the copy of the newspaper sent by the newspaper/ advertisement agency to ensure that advertisement actually appeared in the newspaper.

(ii) See the date of advertisement which appeared in the newspaper should fall in the current accounting year.

(iii) Contents of advertisement should be verified to ascertain that the advertisement was of the entity and was for the business and not of personal nature.

(iv) Ensure the rate charged with the offer received for rates from newspaper and ensure that the size and placement i.e. page is in accordance with the rate charged.

(v) Ensure deduction of TDS and service tax wherever applicable.

(vi) Ensure that it is printed in all issues of the newspaper for which newspaper has charged.

(2) Building Contractor

(i) Evaluate the accounting and the cost accounting systems followed by the company to see whether the profit or loss on each contract can be separately ascertained.

(ii) Examine the method of compilation of costs and treatment of materials, plant etc. purchased for various contracts.

(iii) Determine whether adequate internal controls operate at sites as regard wages, cash, stores and other materials.

(iv) Examine the internal control over the preparation and checking of the bills.

(v) Examine whether the billing has been done regularly in terms of the contracts and escalation costs, if any.

(vi) Examine the accounting for tax deducted at source from the bills and creation of provision for taxation.

(vii) Examine and ascertain the management's decision regarding the method of taking credit in the profit and loss account in respect of unfinished contracts and see that the method, if appropriate, has been followed.

11 (a) Amount Received from an Insurance Company: AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period. The claim for loss of goods in transit is arising out of ordinary activities of the enterprise as a part of its normal course of business. However, the cost of goods lost in transit is only ₹ 8,00,000 while the insurance money received is ₹ 10,00,000. Purchases Account need not be credited since it would distort the purchases done during the year and as also the gross profit. Therefore, entire amount of ₹ 10 lacs needs to be taken to profit and loss account under an appropriate head. This is an income arising from an ordinary activity of the enterprise but having regard to amount involved and exceptional nature, a separate disclosure be made in the profit and loss account. Such disclosure would enable the users to understand the performance of an enterprise for the period.

(b) Cost of Structural Alterations: Any subsequent expenditure on fixed assets which increases the profitability or capacity arising from them beyond their previously assessed standards of performance amounts to capital expenditure and, thus, must form part of the cost of the asset. The words "structural alteration" would generally signify that some significant changes have taken place in the design of building to provide more strength to the building or expansion in the capacity of the building.

Therefore, cost of ₹ 60,000 represents the cost of expansion or extension or may increase the life span of premises, it is a capital expenditure, and an adjustment entry debiting Buildings Account and crediting Building Repairs Account should be made and depreciation should also be provided accordingly.

12. (a) **Capitalisation of Expenses:** A capital expenditure is that which is incurred for the under mentioned purposes:

(a) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits.

(b) Making additions to the existing fixed assets.

(c) Increasing earning capacity of the business.

(d) Reducing the cost of production.

(e) Acquiring a benefit of enduring nature of a valuable right.

Expenses which are essentially of a revenue nature, if incurred for creating assets or adding to its value or achieving higher productivity, are also regarded as expenditure of a capital nature. For Example: Material and wages-capital expenditure when expended on the construction of a building or erection of machinery.

In view of the above, ₹ 2,00,000 has to be added in the cost of Land and Building and cannot be shown as revenue expenditure.

(b) **Auditor's Duty as Regards Depreciation;** Accounting Standard 6 on "Depreciation Accounting" defines depreciation as follows:

"Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, and obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose usefulness is predetermined".

The accounting standard recommends that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

The depreciation has to be provided on semi-permanent assets, e.g., patents, trademarks, blocks and dies, etc apart from fixed assets. Since the auditor is not in a position to estimate the working life of a majority of them, for this he has to rely on the opinion of persons who have a technical knowledge of the assets. He must, however satisfy himself that an honest attempt has been made to estimate the working life of each asset, that the total provision for depreciation is adequate and that the method adopted for determining that amount to be written off appears to be fair and reasonable. If he is of the opinion that the provision for depreciation is not adequate, he should report to the appropriate authority. He must also see that depreciation written off is properly disclosed in the Profit and Loss Account and the Balance Sheet.

13. It would be inappropriate for a person to accept a nomination as auditor under the following circumstances:

(1) **Legal aspect**: Section 226 (3) of the Companies Act, 1956 provides the disqualifications. According to it, the following persons are not qualified to be appointed as auditor of a company:

- An officer or employee of the company
- A person who is a partner or who is in employment of an officer or employee of the company.
- A person who is indebted to the company for an amount exceeding ₹ 1,000 or who has given any guarantee or provided any security in connection with indebtedness of any third person

(2) **Ethical aspect**: Following are the circumstances where a person cannot accept a nomination as auditor on ethical ground:

- A potential conflict of interest between the company and an existing client might arise.
- The person has a personal relationship with a senior member of the company's staff.
- The person is financially involved with the company and wishes to remain so.
- The person might not wish to be professionally associated with this firm for some reason arising out of the need to change auditors.

(3) **Practical aspect**: Following are circumstances where a person cannot accept a nomination as auditor on practical ground:

- The job might be beyond the capacity of the audit firm, because it requires too many staff or expertise not available within the firm.
- The client may have location, which the audit firm cannot visit.
- The client may not be willing to pay the fee that the audit firm would need to charge.

The following steps should be taken when a change of auditors takes place:

(i) The proposed auditor should request permission from the company to contact the previous auditors and if permission is refused, the nomination should be declined.

(ii) The proposed auditor should contact the previous auditor and ensure that there are no professional reasons why he should not accept the appointment.

(iii) The existing auditor must obtain the company's permission to discuss its affairs with the proposed auditor. If refused, the proposed auditor should be informed of this and should then decline the nomination.

(iv) The existing auditor should give the proposed auditor all information relevant to the decision of accepting the appointment.

The purpose of these provisions is to protect both the existing and the proposed auditors. The former by allowing him to express his opinion as to why the change is taking place and the latter by ensuring his decision is made with full knowledge of all circumstances.

14. (a) Under section 228(3)(c) of the Companies Act, 1956 , the company's auditor is required to deal with branch audit report received from the branch auditor, in preparing his report. The manner in which to deal with the report is left to him. This requirement is supplemental to the main duty cast upon him under section 227(3) to state in his report whether the branch audit report has been forwarded to him and how he has dealt with the same. It is clear that the law has left the question of how to deal with the branch audit report to the company auditor and only requires him to state in his report how he has dealt with the same.

In other words, the final judgement rests with the company auditor to decide the prima facie relevant and impact of the branch audit report on the company accounts. This judgement should be taken in light of various SA's issued. SA 600 on "Using the Work of Another Auditor", also states that, "Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or examine the books of account and other records of the said component ". For shown as tallying actually does not tally, he should besides performing additional procedures to ensure that defect is corrected, assess its impact on the internal control system of the branch and on the financial statements of the entity as a whole.

Accordingly, the company auditor will have to decide irrespective of the management's request to check consolidation only, as to whether he has to check the consolidation or go through the regular audit procedure after going through the report of the branch auditor.

(b) According to section 228 of the Companies Act, the audits of the branches can be done by the company auditor himself or by another auditor. The company auditor has right to visit the branch if he deems it necessary to do so for the performance of his duties as auditor. He has also right of access at all times to the books and accounts and vouchers of the company maintained at the branch office. He can appropriately deal with the report of the branch auditor in framing his main report and will disclose it properly.

In this case, the audits of two branches were done by the company auditor and one branch was done by a separate branch auditor. Applying the above provisions, to the instant case, management's objection that the company auditor, is transgressing the scope of audit areas agreed, is absolutely wrong. The right of company auditor in visiting and accessing the records of branch cannot be forfeited

15. (a) Company (Auditor's Report) Order 2003 is applicable to a private limited company if all the following 3 conditions are fulfilled at any point of time -

(i) Paid up capital and reserves are more than ₹ 50.00 Lacs

(ii) Outstanding loan from bank or financial institution is more than ₹ 25.00 Lacs.

(iii) Turnover exceeds ₹ 5 Crores.

In the above case, the paid up capital and reserves are more than ₹ 50 lacs, cash credit limit exceeds ₹ 25 lac (because the Order will apply if on any day during the financial year the loan exceeds ₹ 25 lacs and not the year end balance), and the company's turnover exceeds ₹ 5 crores .

Hence, CARO 2003 will be applicable to the company. The contention of the management that out of sales, goods worth ₹ 40 lacs has been returned by the customer is not tenable. Sales return of next year cannot be reversed or adjusted during the previous year.

(b) (1) Issue of shares for consideration other than cash

(i) Study of the contract pursuant to which the issue is made to determine how many shares are agreed to be issued and for what value and the nature and other details of the consideration.

(ii) Examination of the prospectus to see the substance of the contract and the relevant terms of the issue including the mode of payment of the purchase consideration in case of an issue to a vendor of the business or pay-ability of commission to the underwriters or pay-ability of the preliminary expenses.

(iii) Examination of the Board's minutes to see the adoption of the relevant contract, the decision to issue shares for a consideration other than cash and the actual allotment of shares.

(iv) Verification of the filing of the copy of the contract or the relevant terms of the contract where the contracts is not in writing with the Registrar of Companies within a period of 30 days after the date of the allotment. [as per section 75(1B) of the Companies Act, 1956.]

(v) Ensuring that proper accounting entry has been passed to record the acquisition of the assets or the business or payment of the expenses (any of these may constitute the consideration) on the one hand and the issue of shares on the other. Incidentally, if any premium or discount is involved, ensure that appropriate adjustment entry has been passed therefore.

Sometimes, in view of the nature of transaction, it may be difficult to know whether an allotment is for cash or for a consideration other than cash, for instance, allotment of shares in adjustment of a debt owed by the company. In such a case, if the allotment is made in adjustment of a bonafide debt payable in money at once, the allotment should be considered as against cash.

This position should be kept in view when inquiring into matters stated in section 227(1A). Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash.

(2) Buy-back of shares by the company

(i) Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

(ii) Check authorisation in the Articles of Association which is a prerequisite of any buyback.

(iii) Examine special resolution passed in the general meeting authorising buyback.

(iv) Ascertain that quantum of buy-back is either equal to or less than 25% of the total paid up share capital and free reserves but in case of buy-back of equity shares in any financial year it should not exceed 25% of its total paid-up equity capital in that financial year.

(v) Check that the debt equity ratio should not be more than 2 : 1 except in cases where Central Government allows higher ratio for a class or classes of companies.

(vi) Ensure that shares or other specified securities to be bought back should be fully paid-up.

(vii) Buy-back should be completed within 12 months from the date of passing the special resolution.

(viii) Ascertain that declaration of solvency in Form No.4A was filed with the SEBI and/or the Registrar of Companies before making buy-back but subsequent to the passing of the special resolution.

(ix) See that SEBI (buy-back of securities) Regulations, 1998 have been followed by listed company.

(3) Splitting of shares of face value from ₹ 100 to ₹ 10 per share

(i) Confirm that alteration was authorised by articles.

(ii) Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

(iii) Verify also with reference to Form No.5 filed with the ROC.

(iv) Verify that alteration had been effected in copies of Memorandum, Articles, etc.

(v) Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

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

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

(b) As per provisions of the law, the final dividend of a company shall be declared only by the shareholders based on the recommendation of Board of Directors. The Board can only propose the dividend which shall become final only after approval by shareholders at the AGM. The Board is empowered to declare the interim dividend only. Hence in the given case, the action of Speedy Ltd.'s directors is not in accordance with the law and the auditor should have qualified his report to this effect. The auditors were also required to confirm whether the provision for the same has been made under the Companies Act, 1956. Under the Revised Schedule VI, the only disclosure of proposed dividend required is in Notes to Accounts.

17. (a) Receipt of Donations

(1) *Internal Control System*: Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

(2) *Custody of Receipt Books*: Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of

numbering therein.

(3) *Receipt of Cheques*: Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

(4) *Bank Reconciliation*: Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(5) *Cash Receipts*: Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.

(6) Foreign Contributions, if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of donations to different NGOs

(1) *Mode of Sending Remittance*: All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.

(2) *Confirming Receipt of Remittance*: All remittances are supported by receipts and acknowledgements.

(3) *Identity:* Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(4) *Direct Confirmation Procedure:* Send confirmation letters to entities to whom donations have been paid.

(5) *Donation Utilisation*: Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(6) *System of NGOs' Selection*: System for selecting NGO to whom donations have been sent.

(b) Audit of a partnership firm: The Indian Partnership Act, 1932 does not prescribe audit of a partnership firm. Nevertheless, for the verification of adjustment in the accounts of partners made in respect of profits and losses, interest and remuneration of partners, their contribution to capital, etc. It is necessary that the auditor should have a knowledge of the provisions in this regard under the Act—especially that of powers and partners right to profit and capital under different situations and circumstances. The auditor may, particularly, ensure application of accounting standards prescribed by the Institute. In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards.

Alternatively, only disclosure of non-compliance with the accounting standards would be sufficient without making it a subject matter of qualification.

Advantages: On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows :

(1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.

(2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.

(3) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners and also for the settlement of their liability in respect of Wealth Tax.

(4) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

(5) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

(6) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

18. (a) 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 C&AG. Such an auditor must be a chartered accountant. Further, the Companies Act, 1956, provides that the C&AG shall have the powers:

(i) 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

(ii) 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 C&AG may direct.

The statutory auditor shall submit a copy of his audit report to the C&AG, 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 C&AG. The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

(b) Advantages of Audit to a Sole Trader: Although sole traders are not required by any law (except u/s 44AD, 44AE, 44AB and other provisions of the Income-tax Act, 1961) to have their accounts audited, yet it has become customary for many of them, who derive their large incomes from numerous sources and whose expenditure is vast and varied, to get their accounts audited. Also, sole traders get their financial statements audited due to regulatory requirements, such as stock brokers or on specific instructions of the bank for approval of loans, etc. The sole trader can determine the scope of the audit as well as the conditions under which it will be carried out. For example, he can stipulate that only a partial audit shall be carried out or certain parts of the accounts shall not be checked. It will also be decided that the audit will be carried out continuously or at the end of the year. Thus, the duties and the nature of auditor's work will depend upon the agreement that he has entered into with the sole trader. But he must obtain clear instructions from his clients in writing as to what he is expected to do. The following are some of the advantages that can be derived from an audit of this nature:

(i) The individual is assured of having his accounts properly maintained and his expenditure vouched.

(ii) He is also assured of not being defrauded by the accountant and his agents. Even if they have done some defalcations, etc. these may be discovered by the auditors.

(iii) The audited accounts are reliable and are generally accepted by the Income-tax Department and hence, individuals do not feel any difficulty for taxation assessments, etc.

(iv) The audited accounts of a deceased are very helpful for executors and administrators.

19. (a) Auditors responsibilities relating to the fraud in an audit of financial Statements: The management's request that the amount defaulted by the Executive Director was deposited after the teeming and lading fraud was detected by the auditors and, therefore, no reporting is necessary , is not tenable. It will be necessary for the auditor to bring to the notice of the shareholders about the teeming and lading fraud since the same had been committed by the Executive Director. Such an event shows that the internal control systems are quite weak in the organization and the top management is in a position to abuse its authority. The mere fact that no loss to the company has occurred would not preclude the auditor from bringing it to the notice of the shareholders. A suitable disclosure is called for, particularly, in view of the fact that the fraud has been committed by the Executive Director.

Even SA-240 (Revised) on Auditors responsibilities relating to the fraud in an audit of financial statements require specifically, if the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

Conclusion: Thus, the auditor should also consider the implications of the circumstances on the true and fair view which the financial statements ought to convey and frame his report accordingly.

[Note: The question does not specify the amount of money involve. Therefore, it is difficult to apply the criterion of materiality. But, students would appreciate that smaller the amount involved, the more important it is necessary to disclose the same having regard to involvement of the top management]

(b) Auditor's assessment of materiality: SA 320 on "Materiality in Planning and Performing an Audit" recommends that 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. SA 450 "Evaluation of Misstatements Identified during the Audit", explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

While formulating an overall audit plan, SA 300(Revised) on "Planning an Audit of Financial Statement" also requires the auditor to consider the setting of materiality levels for audit purpose right from the initial stages. Accordingly, the auditor has to assess the materiality aspect right from the initial stages. Accordingly, the auditor has to assess the materiality aspect right from the initial stages of audit planning and throughout the process of conducting the audit till the audit opinions is formulated.

However, the auditor's assessment of materiality may be different at the time of initially planning the engagement than at the time of evaluating the results of his audit procedures. Since audit materiality related to specific amount balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. Such selection of audit procedures would undergo a change as audit work progress. The assessment of materiality and audit risk, the stage of evaluating the results of audit procedures would also change because of a change in circumstances or a change in the auditor's knowledge as results of audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally the auditor may, in planning the audit work, intentionally set the acceptable cut-off level for verifying individual transactions at a lower level than is intended to be used to evaluate the results of the audit. This may be done to cover a larger number of items and thereby reduce the likelihood of undiscovered misstatements and to provide the auditor with the measure of safety when evaluating the effect of misstatements discovered during the audit.

20. (a) Financial Indications and Going Concern: SA 570 on "Going Concern", deals with the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements. The following are the financial indications

to be considered:

- ♦ 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.

(b) Auditor's responsibilities regarding comparatives: SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(i) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(ii) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 (Revised).

As required by SA 580 (Revised), the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

(c) Sampling Risk: As per SA 530 "Audit Sampling", the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

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

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

(d) Reporting on a compilation engagements: SRS 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following layout:

(i) *Title*: The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");

(ii) *Addressee*: The report should ordinarily be addressed to the appointing authority;

(iii) Identification of the financial information also noting that it is based on the information provided by the management;

(iv) When relevant, a statement that the accountant is not independent of the entity;

(v) A statement that the management is responsible for:

- completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;

- maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;

- preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
- establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;
- establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;

(vi) A statement that the engagement was performed in accordance with this Standard on Related Services*;*

(vii) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;

(viii) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;

(ix) Date of the report;

(x) Place of signature; and

(xi) Accountant's signature

The financial statements or other financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" and also "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.