PAPER – 6 : AUDITING AND ASSURANCE

QUESTIONS

Nature of Auditing

1. Comment on the following statements:

   (a) 'Accounting is a necessity, but auditing is a luxury.'

   (b) 'Auditing is a technique of accounting control.'

2. Examples of situations when the auditors' independence may be impaired include the following.

   (a) Providing taxation services to the company and its directors.

   (b) Providing accountancy services, including preparing periodic management accounts and annual financial statements.

   (c) Providing management consultancy, including advice on new computer systems and systems of internal control.

   (d) Preparing confidential reports to the company's bank and other lenders on the financial position of the client. The conclusions of these reports are note made available to the audit client.

   Requirement

   Describe how each of the situations listed above may compromise auditors' independence, and the ways in which an audit firm can minimise the effect which the provision of other services has on independence.

Basic Concepts in Auditing

3. What is the importance of having the accounts audited by independent professional auditors?

4. Briefly explain the nature of accounting policies. State any ten areas in which different accounting policies may be encountered.

Preparation for an Audit

5. What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?

6. **"**While adopting test cheque technique by the auditor for audit work certain precautions should be taken care to establish reliable idea about the true and fairness of the accounts". What precautions are to be taken in the application of test-checking techniques?

Internal Control

7. (a) In a large manufacturing concern, the management suspects inclusion of 'dummy workers' in wage sheets. What would you, as an auditor, suggest to detect such frauds?

(b) Your client, proprietor of a big retail store, wants protection against losses of sale proceeds. The client deals mainly in cash sales. Suggest a suitable system of internal check for the same.

8. You are appointed as an auditor of PQRS Pvt. Ltd.. PQRS Pvt. Ltd. reports the following position as on 31st March, 2010:

Paid up capital	30 lacs
Revaluation reserve	10 lacs
Capital reserve	11 lacs
P&T A/c [Dr. Balance]	2 lacs

The Management of the Company contends that CARO 2003 is not applicable to it. Comment.

Vouching &Verification of Assets and Liabilities

9. You are the Senior Audit Manager of a company's financial statements for the year ended 31st March, 20xx. What evidence would you look for to verify/vouch the following amounts appearing in the financial statements?

(a)	Advertisement expenses	₹ 45,000
(b)	Goodwill	₹ 1, 50,000
(c)	Capital work-in-progress	₹ 85,250
(d)	Wages paid to seasonal labourer	₹ 18,750

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

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

(b) A computerised machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that they would use the machinery equally and show in their Balance Sheets, 50% of the value of the machinery and charge 50% of the depreciation in their respective books of accounts.

11. (a) Give your comments and observations on the No entry is passed for cheques received by the auditee on the last day of the year, but not yet deposited with the bank.

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

12. (a) 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.

(b) As an auditor, how would you safeguard your client against payment for the fictitious purchases while verifying the purchases?

The Company Audit – I

13. Comment on the following:

(a) (i) In case the existing auditor(s) appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy.

(ii) Due to the resignation of the existing auditor(s), the Board of directors of X Ltd appointed Mr. Harry as the auditor. Is the appointment of Harry as auditor valid?

(b) At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?

14. As a statutory auditor of a Public Limited Company, how would you deal with the following situations?

(a) The company has sold some old machinery for ₹ one crore. The details of the cost of such machinery are not available since the entire records relating to fixed assets have been destroyed in an earthquake.

(b) The company had subscribed to shares of associate companies amounting to ₹ 5 crores. These associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The company does not want to make any provision for the fall in the value of the investments.

(c) As at the beginning of the year, the company has a capital of ₹ 2.50 crores, free reserves of ₹ 0.50 crore and Revaluation Reserve of ₹ 4.50 crores. In the relevant year under audit the company has incurred a loss of ₹ 4 crores. The company proposes to adjust the loss with the Revaluation Reserve.

The Company Audit – II

15. Part I, Schedule VI to the Companies Act, 1956, prescribes the form of balance sheet and the requirements relating thereto. What is the specific requirement as per Part I, Schedule VI to the Companies Act, 1956 relating to:

(a) Reserves and Surplus

(b) Current Liabilities and Provisions

16. (a) Can a construction company pay interest out of capital legally? If so, mention the various conditions under which it can do so?

(b) How would an auditor vouch/verify the following?

(i) Forfeiture of Shares.

(ii) Re-issue of Forfeited Shares

Special Audits

17. (a) You are appointed as an auditor of the Apollo Hospital. While conducting the audit of hospital accounts, briefly explain the considerations you will keep in mind.

    (b) Mention the special points to be examined by you as an auditor in the audit of a charitable institution situated in Jaipur.

18. (a) M/s. ABC Ltd., is a partnership firm, approaches you and enquires, whether under any statute it is necessary for a partnership firm, to get their accounts audited, if not than what are the advantage of such audit. You are required to explain the advantages of audit of accounts of a partnership firm?

    (b) Enumerate the matters those should be specially considered in the audit of accounts of a partnership.

Standards on Auditing and Guidance Notes

19. (a) "There should be sufficient liaison between a principal auditor and other auditors". Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor.

    (b) What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client?

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) Reporting on a compilation engagements

SUGGESTED ANSWERS/HINTS

Nature of Auditing

1. (a) Accounting is a necessity, but auditing is a luxury :

It is often told that accounting is a necessity, but auditing is a luxury. The first part of the statement is totally correct, but the correctness of the second part of the statement depends on the situation under which auditing is conducted.

Accounting is necessary to ascertain the financial result as well as financial position of an organisation. Whatever may be the nature, type and size of an organisation, each organisation has to adopt accounting to measure its own performance. In case of a business organisation, profit and loss account and balance sheet are prepared to ascertain the financial result as well as financial position of a particular period of time. Similarly, in case of non-profit seeking organisations, though the objective is not to earn profit, these organisations also prepare accounts to know the surplus generated. Without adopting accounting by maintaining books of accounts for recording financial and economic events, no organisation can maintain its scarce fund and it is also not possible to have idea about the incomes and expenses of the organisation. Hence, it is rightly said that accounting is a necessity.

Auditing is not a luxury in most of the cases. In case of company form of organisations, where ownership is totally separated from the management, auditing ensures the proper utilisation of fund provided by the shareholders and other loan providers. That is why, in the Companies Act, auditing has been made compulsory by introducing required provisions with a view to protect the interest of the shareholders and other interested parties. For the same reason, the co-operative societies and other statutory organisations are also required to conduct audit of their accounts. But auditing is not compulsory in case of sole-proprietorship and partnership firms. If the accounts of these types of organisations are maintained properly and if the proprietor or the partners are confident about the accuracy and reliability of the accounts maintained, then auditing may be considered unnecessary and to some extent luxury. However, if the accounts of these organisations are not audited, they will fail to enjoy some of the important benefits of conducting audit. The banks and other financial institutions provide loans on the basis of audited balance sheet and profit and loss account, the insurance companies settle their insurance claims on the basis of audited balance sheet and even if there is any disagreement among the partners regarding their accounts, the court will give decisions on the basis of audited accounts. Hence, it is inappropriate to say that auditing is a luxury. It is better to say that both accounting and auditing are required to know the true and fair view of the financial position and financial performance of an organisation.

(b) Auditing is a technique of Accounting Control:

The basic functions of accounting are to record the economic events that have the effect in changing the financial position of an organisation and to prepare the financial statements at the end of a particular accounting period. The objectives behind these functions of accounting are to know the financial result and the financial position of that organisation in a particular accounting period and at the end of the accounting period. The users of the financial statements include the management, the shareholders, creditors, investors, loan providing agencies and the public in general.

Auditors are appointed in these organisations to check the authenticity and reliability of the books of accounts maintained by these organisations and the relevant document preserved in order to support the transactions. After checking the books of accounts and relevant documents, the auditors are required to submit a report to the owners of the organisation. In the report, the auditors have to state as to whether the books of accounts maintained by the organisation give a true and fair view of the state of affairs of the organisation as disclosed in the financial statements. If the books of accounts fail to give a true and fair picture of the financial activities of that organisation, the auditor will report accordingly.

In the light of the above two concepts about the functions of accounting and auditing, it can be said that auditing is a technique of accounting control. In keeping the books of accounts or maintaining records through proper recording of economic events of an organisation, the accountants may make mistakes, i.e. accounting error may be there or they may adopt unfair practices to manipulate accounts to mislead the users. If there are accounting errors or frauds in the records and documents, the books of accounts will not disclose the true and fair view of the financial position of the organisation. In conducting audit, the auditor has to go through the entries recorded in the books of accounts and supporting documents to ensure him about the truth and fairness of the financial statements prepared on the basis of the books of accounts maintained. If he finds any inconsistency and irregularity in the books of accounts, he will raise objections and report accordingly. As a result, the persons involved in maintaining the books of accounts and relevant documents become very cautious in discharging their duties, because they know that if there is any irregularity in keeping the books of accounts, the auditor will report against the irregularity. So, the employees involved in maintaining the books of accounts want to be regular in their duties. Hence, it can be rightly said that accounting work is under the control of auditing work and auditing is a technique of accounting control.

2. (a) Taxation services

Many audit firms prepare tax computations for their client companies and this should not normally compromise independence.

Where taxation services are provided to the company, a conflict of interest could arise in dealing with the tax affairs of the directors (example if any of the directors are also shareholders, they may have preferences as to dividends or bonuses, which are not in the best interests of the company's tax or cash flow position).

There may also be independence issues in relation to tax advisory work. For example, the firm may have difficulty in giving an independent view on the acceptability of a scheme to the Revenue or Customs and Excise if the firm designed the scheme itself in the first place.

As a safeguard, a tax manager (or partner) independent of the audit function should be assigned to deal with individual director's tax affairs.

(b) Accountancy services

For many audit clients it is common to provide a range of accountancy services including participation in the preparation of accounting records. For listed or other public interest clients an audit firm should not participate in the preparation of the company's accounts and accounting records except in emergency situations.

Preparing periodic management accounts may draw the auditor, inadvertently, into performing management functions.

Safeguards for non-listed companies include the following.

- The client accepting responsibility for the records as its own.
- The auditor not assuming an operational role.
- Conducting appropriate audit tests on records processed/maintained- by the auditor.

(c) Management consultancy

An auditor's independence may be compromised if a course of action is recommended to an audit client. For example, if the auditor advises on a new computer system which is then found to be unreliable, the auditor may be reluctant to report the weaknesses to management.

As a safeguard auditors should lay the facts before the directors and let them make the decision. It is important that the auditor is not seen to be acting as part of the management function.

The additional guidance on best practice has also now provided that services involving the design and implementation of financial information technology systems (FITS) should not be provided unless

- Management accept overall responsibility in writing
- Management do not rely on the FITS work as the primary basis for determining the adequacy of internal controls and financial reporting systems, and
- The design specifications are set by management.

In any case separate engagement teams are likely to be necessary to mitigate the potential threat to independence.

(d) Preparing confidential reports

Auditors are not prevented from producing confidential reports for banks and other lenders, provided they have obtained the client's authority to do so.

An 'unqualified' confidential report recently issued to a lender may be borne in mind when forming the audit opinion. This may increase pressure not to qualify the audit opinion (to add credibility to the confidential report) when qualification is justified.

A partner other than the audit engagement partner should be responsible for the confidential reports. Unless confidentiality is absolutely necessary, the client should be made aware of the reports to lenders. The quality of these reports may be enhanced by consideration of management's views on matters included.

Basic Concepts in Auditing

3. Importance of Audit by an Independent Professional Auditor

The principal advantage of an independent audit lies in the fact that the society is able to get an informed, objective and forthright opinion on the financial statements of enterprises which are used in making significant economic decisions by interested segments of the society, e.g., shareholders, creditors, bankers, etc. Irrespective of the fact whether audit is compulsory, statutory or voluntary, the audit of accounts by an independent professional auditor becomes important for every individual and every type of organisation.

It is only through audited accounts by an independent professional auditor that the shareholders of a company are assured that the funds invested by them are safe and they are being used for only the purposes for which they were raised and collected. The chief utility of audit lies in ensuring reliable financial statements on the basis of which the state of affairs may be easy to understand. Information contained in the statement of accounts of a business is primarily intended for the owners.

However, many others make use of the information for different purposes.

- Management of the business uses it for decision-making purposes.
- Lenders and creditors examine it to establish the degree of safety of their money.
- Government levies tax putting a *prima facie* reliance on the statements and regulates the socio-economic state of affairs on a summary view of the information contained in various accounting statement made available to it.
- Investors review the information for making investment decisions
- Financial analysts can use the information to assess the performance of an entity.

Financial statements are of great significance to workers as well; they want to be assured that reasonable and legitimate share of the revenue earned by the organisation has been paid to them as bonus and the distribution pattern has not violated the norms of social justice.

To ensure the acceptable degree of reliability and accuracy of the financial statements, examination and appraisal of accounts and the financial picture by an independent auditor is necessary.

In the company form of organisation, there is a divorce between ownership and management - shareholders are so scattered that they have no direct control on the day-today administration of the company while in a proprietary concern, accounts may be audited to get funds from financial institution, etc. and a partnership firm may get its accounts audited to decide questions such as valuation of goodwill at the time of admission, retirement and death of a partner.

The report of an independent auditor is, therefore, the only real safeguard available to the various parties interested in the financial affairs of the entity. It is due to the independence of the auditor, leading to an objective report, that the risk of people being misled by untrue or fraudulent financial statement is minimised. As a by-product, managements get attuned to open and truthful financial statements.

4. Nature of Accounting Policies

Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

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

The various statements of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternative particularly in the case of a corporate enterprise. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those stances faced by the enterprises.

Areas in which Different Accounting Policies are encountered

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

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

(ii) Treatment of expenditure during construction i.e. write off, capitalization, deferment.

(iii) Conversion or translation of foreign currency items-average rate, actual, TT buying rate etc.

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

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

(vi) Valuation of investment –at cost, market or net realisable value etc.

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

(viii) Recognition of profit on long term contracts –year to year, % completion etc.

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

(x) Treatment of contingent liabilities.

Preparation for an Audit

5. Knowledge of the Business :

The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”. These are:

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

(ii) The nature of the entity, including:

(a) its operations;

(b) its ownership and governance structures;

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

(d) 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.

(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.

6. The precautions that should be taken in applying test checking are-

(i) The transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of same kind.

(ii) Systems and procedures of entering and processing a transaction right from the beginning to the end should be studied in a sequential order. It involves question of authorisation, documentation and recording, and evidencing the same.

(iii) The complete system of internal control in areas of accounts and finance should be studied and evaluated for its efficiency, soundness and capability for producing reliable accounting and financial data. This can be done by studying the controls and internal checks, evaluating their general soundness in the context of the business of the concern and testing their actual operation. Depending upon the auditor's satisfaction about the soundness of the controls and the operation of control systems, he should select a few transactions and check them in depth by the application of procedural tests.

(iv) A properly thought-out test check plan should be prepared and the objective of each check should be clearly understood by the auditing staff. For example, cash vouchers may be checked by the test check method for a number of objectives:

(a) One may be to ensure that the cash payments are properly authorised and acknowledged.

(b) Other may be to see whether the payment has been debited to the proper account, if there is a mix-up in the objectives or the objective is to be test a number of variables in one test scheme, the result may not be helpful. Hence, it requires a clear definition of the audit objective related to the particular test check plan.

(v) The transactions falling under such tests – check plan should be selected in a manner that bias does not enter the selection. For this purpose, selection should be made by reference to the random number tables.

(vi) Identification of the areas where test check may not be done. For example, if there are only 20 overseas sales in the year, it would be preferable to have them all thoroughly checked.

(vii) The number of transactions to be selected for each test check plan should be pre-determined. This can be done by deciding upon the degree of reliance that should be placed on the test-check results and the confidence that can be placed the results to be obtained should be veering round the degree of reliance set-up. Once the degree of reliance and the confidence level required in the audit for expression of the opinion have been decided, the number to be tested out of the given population can be easily known by reference to the statistical tables.

(viii) Materiality of the error as a result of test check must be pre-determined and criteria to be fixed to judge the same. Only the material errors may be properly and thoroughly investigated.

Internal Control

7. (a) Effective and appropriate internal control system should be adopted in order to detect the inclusion of the names of dummy workers in the wage sheets. The application of suitable internal check system depends on the nature and procedures of wage payment of the factory concerned. However, following outlines of the system can be suggested:

(i) Each worker should be provided with a time card or job card as the case may be. Proper records in detail about each worker must be maintained in such cards. The foreman in charge should initial the entries in the cards. At the end of the week or month, the card should be sent to wages office.

(ii) Due care should be given in the preparation of wage sheets. Wage sheets should not be prepared by those employees, who are responsible for recording the attendance of the workers. The work of wage sheet preparation should be assigned to a number of employees in such a way that the work done by one is automatically checked by the other.

(iii) Payment of wages should not be made by those employees, who have taken part in the preparation of wage sheet. It should be done by the cashier in the presence of a responsible officer and also the foreman, who can recognise the workers.

(iv) Proper records related to overtime authorised and granted to the workers must be maintained. For casual workers, separate records should he maintained.

(b) Internal Check for the Misappropriation of Cash out of the Sale Proceeds:

With a view to protect against the misappropriation of cash out of the sale proceeds by the salesmen, the following system of internal check is suggested:

(i) There should be complete segregation of responsibilities of the salesmen, the cashier and the accountant. Nobody should be allowed to do the job of others.

(ii) For each section, counter or department, separate salesman should be appointed.

(iii) As far as possible, mechanical cash register should be maintained.

(iv) The salesman should issue sales bills in triplicate. He should hand over two copies to the customer and retain the other copy.

(v) These two copies of the bill should be presented by the customer to the cashier.

(vi) The cashier should check the bill, receive the payment and stamp the bill as 'Paid'. Original copy of the bill should be handed over to the customer.

(vii) The customer should collect the goods purchased on presentation of the original bill, stamped as paid from another counter near the gate.

(viii) Each salesman should prepare the summary sheet with the help of the copy of the bill that remains with him and submit it to the accountant.

(ix) The cashier should enter the day's total sales in the cash sales sheet with the help of bill retained by him and report it to the accountant.

(x) Any discrepancy found by the accountant should be immediately reported to the general manager.

8. Applicability of CARO, 2003

As per the Statement on CARO, 2003 issued by ICAI, for determining the applicability of the CARO to a private limited company, both capital as well as the revenue reserves shall be taken into consideration while computing the limit of rupees fifty lacs prescribed for paid up capital and reserves. Revaluation reserve, if any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. The credit balance in the profit and loss account should also be considered as a part of reserve since the balance in the profit and loss account is available for general purposes like declaration of dividend. The debit balance in the profit and loss account, if any, should be reduced from the figure of revenue reserves only. If the company does not have revenue reserves, debit balance of profit and loss account cannot be reduced from the figures of paid up capital, capital reserve and revaluation reserve.

Accordingly the profit and loss account (Dr Balance) of ₹ 2 lacs cannot be deducted and hence CARO, 2003 is applicable to the Company.

Vouching and Verification of Assets and Liabilities

9. (a) **Advertisement E*xpenses* ₹ 45,000:** The following steps may be taken by the auditor to vouch/verify the different items:

(i) Ascertaining the value of advertisement expenses to ensure that the said expense has been properly allocated.

(ii) Examining that such expenses relate to the client's business.

(iii) Review and examination of the complete list of media of advertisement indicating the dates, location, timing, etc., along with the amounts paid in respect of each category.

(iv) Examination of the receipts for amounts paid.

(v) Reviewing the contracts with the different agencies and ensuring that the billing conforms to the term and conditions specified therein.

(vi) Ensuring that all such outstanding expenses have been properly accounted for.

(b) **Goodwill ₹ 1,50,000:** Goodwill arises from business connections, trade name or reputation of an enterprise. AS 26, "Intangible Assets", states that internally generated goodwill is not to be recognised as an asset, as it is not an identifiable resource controlled by the enterprise, which can be measured reliably at cost. As per AS 10, "Accounting for Fixed Assets", goodwill should be recorded in the books, only when some consideration in money or money's worth has been paid for it. In light of the above discussions, the following points are to be noted for verification of goodwill:

(i) Examine the vendors' agreement on the basis of which assets of the running business have been acquired by the company as per the books of account or a specific amount has been paid for the goodwill.

(ii) Ensure that whenever business is acquired at a price, payable in cash or otherwise, which is in excess of the value of net assets taken over, such excess amount is the goodwill.

(iii) Ensure that only the amount paid to the vendors not represented by tangible or intangible assets, the value of which can be measured reliably has been debited to goodwill account.

(iv) See that goodwill has not been shown in the company's books by writing up the value of its assets, on revaluation, or by writing back the amount of goodwill earlier written off.

(v) Ensure that the goodwill not yet written off has been properly disclosed under the head "Fixed Assets" as per Schedule VI requirements.

(vi) See that the goodwill is being amortised as per financial prudence over a reasonable period.

(c) Capital Work-in-Progress ₹ 85,250: Capital Work-in-Progress denotes assets under installation. This could either be plant or machinery under construction, or that construction project for establishment of a new factory is under progress. The auditor should take the following steps to verify the same.

(i) Ensure that the capital project is authorised by the Board. See the relevant Board Minutes for the purpose.

(ii) Obtain the break up in details of the amount shown in the Balance Sheet under this head.

(iii) Check purchase cost of plant, machinery or other assets with reference to the contract with, and amount paid to the suppliers.

(iv) Examine the allocation of common costs to the Capital Work-in-Progress in case such items have been constructed internally.

(v) Ensure that the assets already put to commercial use are not included under Capital Work-in-Progress.

(vi) Verify that only expenses incurred up to pre-commissioning stage are capitalised under this head.

(vii) Obtain the certificate of the engineering department to ascertain the quantum of the Capital Work-in-Progress, and whether the value is correctly represented in the Balance Sheet, and its transfer to Fixed Assets on completion of the project or installation of the plant.

(viii) See that Capital Work-in-Progress is properly disclosed in the Balance Sheet under the head Fixed Assets.

(d) Wages Paid to Seasonal Labourers ₹ 18,750

(i) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.

(ii) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.

(iii) Ensure that the attendance is properly checked by the Time Keeping Department.

(iv) Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis.

(v) Check the computation of wages payable to the labourers, after taking into account the deductions.

(vi) Confirm that all the payment to the labourers have been acknowledged.

(vii) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.

(viii) Reconcile the number of seasonal labourers on payroll as per the Personnel Department's records vis-à-vis the number of labourers to whom the wages have been paid, to ensure that there are no ghost workers. This assumes greater importance, if the seasonal labourers are hired on temporary basis, and not on permanent payroll.

10. (a) Consideration of Subsequent Events: SA 560 "Subsequent Events" requires that the auditors should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements. AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" also classifies an adjusting event which provides further evidence of conditions that existed at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of debtors as also the realisability aspect. The auditor's duties in respect of debtors remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from debtors. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31, 2004. Accordingly, the auditor would have now to see that in respect of outstanding amount of rupees 35,000, whether the amount of provision needs any revision.

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

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

11. (a) Cheques Received on the last day of Accounting Year: It is quite normal that in any on going business entity many a time's cheques are received from the customers on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank. Though normally speaking, it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.

As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the debtors' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the debtors' ledger should ensure that proper accounting entries have been passed by crediting respective debtors' accounts. The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

(b) 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

12. **(a)** 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.

(b) The auditor has to be very cautious while verifying the purchases that no payments have been made for the fictitious purchases. For this purpose, he may have to take the following actions:

- He should examine first the internal control system in connection with purchases and satisfy himself with regard to its effectiveness.
- He should ensure that before passing the invoices for payment, they are checked with the original order, with goods received book and the stock records.
- He should inspect the invoices and see that the authorities responsible for passing them for payment have duly checked them and initialled.

- He should test check the invoices to see that-dates given in the invoices are for the period concerned and they have been addressed in the name of the client.
- He should also compare a number of invoices with the records in the goods received book and stock records.
- He can make physical verification of the goods purchased, if a part of it is still in the stock.
- He should also compare the supplier's statement with the supplier's account.
- Postings in the various suppliers' accounts should also be checked and compared with the statement received from them.

The Company Audit – I

13 (a) (i) ***Board's Powers to Appoint an Auditor*** : The appointment of an auditor is complete only on the acceptance of the offer by the auditor. The non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one, the matter would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. The casual vacancy is said to arise only in case of death, resignation, etc. Therefore, the Board is not empowered to fill such a vacancy. Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditor (s) appointed at the Annual General Meeting refuse to accept the appointment.

(ii) ***Board's Powers to Appoint an Auditor*** **:** The resignation of the existing auditor(s) would give rise to a casual vacancy. As per Section 224(6) (a) of the Act, casual vacancy can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. The rationale behind such a provision is to ensure that resignation is a matter of great concern and, thus, it is necessary that all shareholders must be apprised of reasons connected with resignation in case of a casual vacancy arising on account of resignation. The vacancy shall only be filled by the company in general meeting. Thus the appointment of Mr. Harry as the auditor of the company is not valid.

(b) ***Restrictions on Powers of Statutory Auditors*****:** Section 227(1) of the Companies Act, 1956 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit. These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence' any such resolution even if passed by entire body of shareholders is *ultra vires* and therefore void. In the case of *Newton vs. Birmingham Small Arms Co.*, it was held that any regulations which preclude the auditors from availing themselves of all the information to which they are entitled under the Companies Act, are inconsistent with the Act.

14. (a) Sale of Machinery: AS 10 on "Accounting for Fixed Assets", gains or losses arising on disposal are generally recognised in the profit and loss statement. Therefore, when the company sells old machinery, profit or loss on sale thereof has to be determined. Such profit or loss can be determined provided the cost and written down value of the said machinery is available. In the instant case, since the entire records of fixed assets have been destroyed, the cost and the WDV of the machinery sold could not be arrived at. The company may therefore, have to determine the same on some estimated basis provided all reasonable efforts to determine the cost/WDVs of the machinery do not yield any better result. An all out attempt should be made by the management to reconstruct the old records. Such records may be constructed by obtaining old copies of annual reports distributed amongst shareholders, annual accounts filed with Registrar of Company, IT Returns filed by the auditor may also be having record of physical verification of earlier years etc. In fact, through this process, the company shall be able to determine the WDV of the asset because the machinery sold seems to be quite big and must have been recorded on stand alone basis.

The auditor will have to see whether the estimate of cost and WDV arrived at in the above manner by the company is reasonable and whether the profit or loss is determined accordingly. A note to that effect would also have to be given by the management in the accounts. If the auditor is of the opinion that the said estimates are satisfactory based on available records and the note given by management explains the said fact, he may not qualify his report. If he is not so satisfied, he would have to give disclaimer in the audit report that in the absence of proper records, the said profit or loss has been arrived on an estimated basis and in that view he has been unable to form an opinion. As far as the report under the CARO, 2003 order is concerned, the auditor would have to point out that proper records of fixed assets showing full particulars as required by that clause are not available.

(b) Valuation of Investments: AS 13 on "Accounting for Investments" requires investments to be classified as long term and current investments distinctly in its financial statements. Since the investment in share of associate company is intended to be kept for a period more than one year, they would be classified as long term investment.

AS 13 states, "long-term investments should be carried in the financial statements at cost." However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. In the instant case, these associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The net worth of these companies would have been wiped out resulting in a fall in the value of the investments. Therefore, such fall cannot be merely temporary as the companies could take a long time to turn around (if at all) and again have a positive net worth. The auditor would therefore have to qualify his report by saying that no provision for diminution for fall in the value of investments as required by AS 13 has been made and to that extent the profits and reserves have been overstated.

(c) **Adjustment of Loss against Revaluation Reserve:** AS 10 on "Accounting for Fixed Assets" states that an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease. The Guidance Note on "Treatment of Reserve created on Revaluation of Fixed Assets" states that where the value of fixed assets is written up in the books of account of a company, the corresponding credit appearing as revaluation reserve does not represent a realised gain and is, therefore, not available for distribution as dividend. Similarly, accumulated losses and the depreciation on the acquisition cost (including arrears of depreciation) should not be adjusted against revaluation reserve since this would amount to setting off actual losses against unrealised gains.

The auditor should explain to the management that accumulated losses cannot be adjusted against the revaluation reserve created on revaluation of the fixed assets. In case the company in question does so, the balance sheet of the company will not reflect a true and fair view of the state of affairs of the company keeping in view the magnitude of the amounts involved, i.e., accumulated losses amount to ₹ 4 crores and share capital and reserves amount to ₹ 3 crores (excluding revaluation reserve). If the management does not agree with the opinion of the auditor, the auditor may even issue an adverse report.

The Company Audit – II

15 **(a)** ***Reserves and Surplus***: This item should be classified as under:

1. Capital Reserves.
2. Capital Redemption Reserve.
3. Share Premium Account.
4. Other Reserves specifying the nature and amount of each Reserve.
5. Surplus.

6. Proposed additions to Reserves.
7. Sinking Funds.

Under each of the above specific heads, the balance as per last balance sheet, additions thereto and deductions therefrom should be stated.

The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.

In respect of the Share Premium Account, details of its utilisation in the manner provided in section 78 should be given in the year of utilisation.

In respect of other reserves, the nature and the amount of each reserve should be specified.

Any debit balance in the Profit and Loss Account should be shown as a deduction from the uncommitted reserves, if any.

The expression "Uncommitted reserves', would not include reserves set apart for a specific purpose such as reserve for doubtful debts, investment, fluctuation reserve, etc.

Under "Surplus" should be shown the balance in the Profit and Loss Account after providing for proposed allocations, namely, Dividend, Bonus or allocations to Reserves.

While classifying the items between Reserves and Provisions regard must be had to the definitions of these items given in Part III, Schedule VI, and accordingly any provision in excess of the amount reasonably necessary should be classified as a reserve.

(b) ***Current Liabilities and Provisions****:* Current Liabilities and Provisions are required to be grouped separately as under:

(A) Current Liabilities

1. Acceptances.
2. Sundry Creditors.
   (i) Total outstanding dues of micro enterprises and small enterprises; and
   (ii) Total outstanding dues of creditors other than micro enterprises and small enterprises.
3. Subsidiary Companies.
4. Advance payments and unexpired discounts for the portion for which value has still to be given, *e.g.,* in the case of the following classes of companies :

   Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steam-ship Companies, etc.

5. Investor Education and Protection Fund shall be credited by the following amounts namely:
   - (a) Unpaid dividend;
   - (b) Unpaid application money received by the companies for allotment of securities and due for refund;
   - (c) Unpaid Matured Deposits;
   - (d) Unpaid Matured Debentures;
   - (e) Interest accrued on (a) to (d) above.
6. Other Liabilities.
7. Interest accrued but not due on loans.

(B) Provisions

8. Provision for Taxation.
9. Proposed Dividends.
10. For Contingencies.
11. For Provident Fund Scheme.
12. For Insurance, pension and similar staff benefit schemes.
13. Other provisions.

The items should be classified as "Provision" of "Liabilities" having regard to the definitions of these terms in Part III, Schedule VI.

Current accounts with directors and manager, whether they are in credit or debit, should be shown separately.

It should be noted that interest accrued but not due on loans, whether secured or unsecured, is required to be shown under "Current Liabilities".

The provision for taxation, if in excess of the amount, which in the opinion of the directors, is reasonably necessary for the purpose, should be classified as a "Reserve".

The name(s) of the small scale industrial undertaking(s) to whom the company owe any sum together with interest outstanding for more than 30 days are to be disclosed.

16. (a) In general, a company cannot pay interest out of its capital. It is only when a company has been formed to undertake some construction or other related work and would not be able to earn sufficient profits for some years, it can legally pay interest on the paid-up capital.

According to Sections 208(2) to 208(7) of the Companies Act, 1956 the following conditions must be fulfilled before such payment can be made:

- Payment must be authorised by the Articles or by a special resolution.

- No such payment, even though authorised as mentioned above, shall be made without the previous sanction of the Central Government.
- The Central Government may, at the expense of the company, appoint a person to inquire into the circumstances and to report to the Central Government.
- The payment of interest shall be made only for such periods as may be determined by the Central Government.
- The rate of interest, in no case, exceeds 4% per annum or such other rate as the Central Government may direct by a notification in the official gazette.
- 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) (i) Forfeiture of Shares

The auditor should:

(1) ascertain that the Articles authorise the Board of Directors to forfeit shares and that the power has been exercised by the Board in the best interest of the company;

(2) verify the amount of call or instalment of calls which was outstanding in respect of each of the share forfeited;

(3) ascertain that the procedure in the Articles has been followed, viz., the notice given (14 days, according to Table A) to the defaulting shareholders, warning them that in the event of non-payment, by a specified date, of the amount of call already made on the shares standing in their names, together with interest, if any, the shares shall be forfeited; see that the proper resolutions of Directors, first as regards issuance of notice and afterwards in respect of forfeiture of shares; and

(4) verify the entries recorded in the books of account consequent upon forfeiture of shares to confirm that the premium, if any, received on the issue of shares has not been transferred to the Forfeited Shares Account.

(ii) Re-issue of Forfeited Shares

The auditor should:

(1) ascertain that the Board of Directors has the authority under the Articles to re-issue forfeited shares;

(2) refer to the resolution of the Board of Directors, re-allotting forfeited shares;

(3) vouch the amounts collected from person to whom the shares have been allotted and verify the entries recorded from re-allotment and see that the total amount received on the share, including that received prior to forfeiture, is not less than the par value; and

(4) verify that computation of the amount of surplus resulting on the reissue of shares credited to the Capital Reserve Account; and

(5) where partly paid shares are forfeited for non-payment of call, and are re-issued as fully paid, the re-issue is treated as an allotment at a discount *Biochemical and Synthetic Products Ltd.* v. *Registrar of Companies* [(1962) 32 Comp. Case 654]. In such a case the provisions of Section 79 would require compliance.

Special Audits

17. (a) Audit of Hospital

The special steps involved in such an audit are stated below;

(i) Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(iii) See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.

(iv) Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(vi) Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(vii) Verify that grants, if any, received from Government or local authorities have been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(viii) Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.

(ix) Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.

(x) See that depreciation has been written off against all the assets at the appropriate rates.

(xi) Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) Obtain inventories, specially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

(b) Audit of Charitable Institutions

In the case of the audit of a charitable institution, attention should be paid to the following matters :

(i) *General*

(a) Studying the constitution under which the charitable institution has been set up. It may be registered as a society under the Societies Registration Act, 1860 as a company limited by guarantee or as a trust. If the charitable institution is a public trust, the provision of the State Legislation, if any, affecting its accounts and audit should be taken into account.

(b) Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.

(c) Examining the system of internal check, especially as regards accounting of amounts collected.

(d) Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.

(ii) *Subscriptions and donations*

(1) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

(2) Whether official receipts are issued;

(a) confirming that adequate control is imposed over unused receipt books;

(b) obtaining all receipt books covering the period under review;

(c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;

(d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;

(e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

(f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

(iii) *Legacies* - Verifying the amounts received by reference to correspondence with any figures and other available information.

(iv) *Grants*

(a) Vouching the amount received with the relevant correspondence, receipts and minute books.

(b) Obtaining a certificate from a responsible official showing the amount of grants received.

(v) *Investments Income*

(a) Vouching the amounts received with the dividend and interest counterfoils.

(b) Checking the calculations of interest received on securities bearing fixed rates of interest.

(c) Checking that the appropriate dividend has been received where any investment has been sold ex. dividend or purchased cum. dividend.

(d) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(vi) *Rents*

(a) Examining the rent roll and inspecting tenancy agreements, noting in each case :

(1) The amounts of the rents, and

(2) The due dates.

(b) Vouching the rents on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

(vii) *Special function, etc.* - Vouching gross receipts and outgoings in respect of any special functions, *e.g.* concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.

(viii) *Income Tax Refunds* - Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves :

(a) vouching the Income-tax refund with the correspondence with the Income-tax Department; and

(b) checking the calculation of the repayment of claims.

(ix) *Expenditure*

(a) Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the Managing Committee has benefited therefrom either directly or indirectly.

(b) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test-basis.

(c) Verifying the cash and bank balances.

(d) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

18. (a) Advantages of Audit of a Partnership Accounts

The advantages of audit of accounts of a partnership could be stated as follows:

(i) 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.

(ii) 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.

(iii) 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.

(iv) Audited statements 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.

(v) 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.

(vi) 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.

(b) Specific Matters to be considered in Audit of a Partnership Accounts

Matters which should be specially considered in the audit of accounts of a partnership are:

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

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

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

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

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

(vi) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

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

From the foregoing steps involved in the audit of a partnership it would be observed that like the audit of every other commercial undertaking, it culminates in the verification of the Balance Sheet and the Profit and Loss Account to ensure that these exhibit a true and fair state of affairs of the firm.

Standards on Auditing and Guidance Notes

19. (a) SA 600 on "Using the Work of Another Auditor" lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report

(b) As per SA 520 "Analytical Procedure", when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:

(i) Objective of such procedures and the extent to which he may be able to rely on their results.

(ii) Nature of the entity and the degree to which information can be disaggregated; for example, analytical procedures may be effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) Availability of information, both financial, such as budgets or forecasts, and nonfinancial such as the number of units produced or sold.

(iv) Reliability of the information available

(v) Relevance of the information available

(vi) Sources of information available

(vii) Comparability of the information available

(viii) Knowledge gained by the auditor during previous examinations.

(ix) Testing the controls over the preparation of non financial information, if any, used in applying analytical procedures.

20. (a) Financial Indications to be considered for evaluating the assumption of going concern:

SA 570 "Going Concern", aims to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements. The following are the financial indications be considered:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of Going Concern 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.
- Entering into a scheme of arrangement with creditors for reduction of liability.

(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) "Subsequent Events".

As required by SA 580 (Revised)"Written Representation", 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) Reporting on a Compilation Engagements:

As per SRS 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following lay out:

(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.

ANNEXURE

LIST OF INSTITUTE'S PUBLICATIONS RELEVANT FOR MAY, 2011 EXAMINATION

The following List of Institute's Publications is relevant for the forthcoming examination i.e. May, 2011. Students may kindly take it into consideration while preparing for the examination.

Integrated Professional Competence Course

Paper 6 : Auditing and Assurance

I. Statements

1. Statement on Reporting under Section 227 (1A) of the Companies Act, 1956

   http://220.227.161.86/18799announ10264b.pdf

2. Statement on the Companies (Auditor's Report) Order, 2003 (2005 Edition)

   http://220.227.161.86/18798announ10264a.pdf

II. Standards on Auditing (SAs)

S.No	SA	Title of Standard on Auditing	Effective Date
1	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing http://220.227.161.86/18132sa200_rev.pdf	April 1, 2010
2	SA 210	Agreeing the Terms of Audit Engagements http://220.227.161.86/16837sa210revised.pdf	April 1, 2010
3	SA 220	Quality Control for an Audit of Financial Statements http://220.227.161.86/18133sa220_rev.pdf	April 1, 2010
4	SA 230	Audit Documentation http://220.227.161.86/15372Link7_SA230-standard.pdf	April 1, 2009
5	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements http://220.227.161.86/15374Link9_240SA_REVISED.pdf	April 1, 2009
6	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements http://220.227.161.86/15376Link11_SA250-text.pdf	April 1, 2009

7	SA 260	Communication with Those Charged with Governance http://220.227.161.86/15378Link13_SA%20260-text.pdf	April 1, 2009
8	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management http://220.227.161.86/16838sa265.pdf	April 1, 2010
9	SA 299	Responsibility of Joint Auditors http://220.227.161.86/15379Link14_299SA-AAS12.pdf	April 1, 1996
10	SA 300	Planning an Audit of Financial Statements http://220.227.161.86/15381Link16_300SA_REVISED.pdf	April 1, 2008
11	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment http://220.227.161.86/15382Link17_315SA.pdf	April 1, 2008
12	SA 320	Materiality in Planning and Performing an Audit http://220.227.161.86/16839sa320revised.pdf	April 1, 2010
13	SA 330	The Auditor's Responses to Assessed Risks http://220.227.161.86/15384Link19_330SA.pdf	April 1, 2008
14	SA 402	Audit Considerations Relating to an Entity Using a Service Organization http://220.227.161.86/16840sa402revised.pdf	April 1, 2010
15	SA 450	Evaluation of Misstatements Identified during the Audits http://220.227.161.86/16841sa450revised.pdf	April 1, 2010
16	SA 500	Audit Evidence http://icai.org/resource_file/15576sa500revised.pdf	April 1, 2009
17	SA 501	Audit Evidence - Specific Considerations for Selected Items http://220.227.161.86/18134sa501_rev.pdf	April 1, 2010
18	SA 505	External Confirmations http://220.227.161.86/18135sa505_rev.pdf	April 1, 2010
19	SA 510	Initial Audit Engagements-Opening Balances http://220.227.161.86/15390Link25_510text.pdf	April 1, 2010
20	SA 520	Analytical Procedures http://220.227.161.86/18136sa520_rev.pdf	April 1, 2010
21	SA 530	Audit Sampling http://220.227.161.86/15393Link28_530text.pdf	April 1, 2009
22	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures http://220.227.161.86/15395Link30_540text.pdf	April 1, 2009
23	SA 550	Related Parties http://220.227.161.86/15397Link32_550text.pdf	April 1, 2010
24	SA 560	Subsequent Events http://220.227.161.86/15399Link34_SA%20560_Standard_OK OK.pdf	April 1, 2009
25	SA 570	Going Concern http://220.227.161.86/15401Link36_SA570-final_standard.pdf	April 1, 2009
26	SA 580	Written Representations http://220.227.161.86/15403Link38_sa580.pdf	April 1, 2009
27	SA 600	Using the Work of Another Auditor http://220.227.161.86/18836sa600_aas.pdf	April 1, 2002
28	SA 610	Using the Work of Internal Auditors http://220.227.161.86/16842sa610revised.pdf	April 1, 2010

29	SA 620	Using the Work of an Auditor's Expert http://220.227.161.86/18137sa620_rev.pdf	April1, 2010
30	SA 700	Forming an Opinion and Reporting on Financial Statements http://220.227.161.86/17874sa700annx1.pdf	April 1, 2011
31	SA 705	Modifications to the Opinion in the Independent Auditor's Report http://220.227.161.86/17875sa705annex2.pdf	April 1, 2011
32	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report http://220.227.161.86/17876sa706annex3.pdf	April 1, 2011
33	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements http://220.227.161.86/18793annex1SA710.pdf	April 1, 2011
34	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements http://220.227.161.86/15578sa720ann.pdf	April 1, 2010
35	SRE 2400	Engagements to Review Financial Statements http://220.227.161.86/18727annex1200410.pdf	April 1, 2010
36	SRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity http://220.227.161.86/18728annex2200410.pdf	April 1, 2010
37	SAE 3400	The Examination of Prospective Financial Information http://220.227.161.86/15410Link45_3400SAE-AAS35.pdf	April 1, 2007
38	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information http://220.227.161.86/15411Link46_4400SRS-AAS32.pdf	April 1, 2004
39	SRS 4410	Engagements to Compile Financial Information http://220.227.161.86/15412Link47_4410SRS-AAS31.pdf	April 1, 2004

*Effective date means that the SA is effective for audits of the financial statements for periods beginning on or after the specified date

III. Guidance Notes/Study Guide/Monograph

1. Guidance Note on Audit of Fixed Assets.
2. Guidance Note on Audit of Inventories.
3. Guidance Note on Audit of Debtors, Loans and Advances.
4. Guidance Note on Audit of Investments.
5. Guidance Note on Audit of Miscellaneous Expenditure.
6. Guidance Note on Audit of Cash and Bank Balances.
7. Guidance Note on Audit of Liabilities.
8. Guidance Note on Audit of Revenue.
9. Guidance Note on Audit of Expenses.
10. Guidance Note on Provision for Proposed Dividend

** Text of applicable Guidance notes is available in the Volume II of Paper -2, Auditing and Assurance Study Material. These can be accessed by following the path - http://www.icai.org/post.html?post_id=6192