

## PAPER – 6: AUDITING AND ASSURANCE

### PART – I : ACADEMIC UPDATE

(Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by Regulating Authority)

1. **Ceiling on Number of Company Audits:** As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.
2. **Guidance Note on Reporting under Section 143(3)(f) and (h) of the Companies Act, 2013:**

#### **Introduction**

1. Section 143 of the Companies Act, 2013 (hereinafter referred to as the "Act") deals with the powers and duties of the auditors of companies. Section 143(1) of the Act requires the auditor to make certain specific enquiries during the course of the audit. Section 143(2) of the Act requires the auditor to, *inter alia*, give his report to the members of company on the accounts examined by him, and on every financial statement which are laid before the company in a general meeting. Sub-section (3) of section 143 of the Act also lays down certain matters required to be reported upon by the auditor in his report. Sub-section (3) of section 143 of Act provides as follows:

"(3) The auditor's report shall also state -

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
- (j) such other matters as may be prescribed.<sup>1</sup>

#### Scope of the Guidance Note

2. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (f) and (h) of sub-section (3) of section 143 of the Act. Clause (f) of the said sub-section creates a requirement for the auditor to consider observations or comments of the auditor on financial transactions or matters which have an adverse effect on the functioning of the company. Such observations or comments would ordinarily lead to the modification of or an emphasis of matter in the auditor's report on financial statements. It may be noted that the matters that lead to modification in the auditor's report on financial statements are matters that give rise to a qualified opinion, adverse opinion or a disclaimer of opinion<sup>2</sup>. Further, matters that lead to an emphasis of matter paragraphs are matters appropriately presented or disclosed in the financial statements that, in the auditor's judgement, are of such importance that they are fundamental to the users' understanding of the financial statements<sup>3</sup>. If the matter leading to the modification of the auditor's opinion or an emphasis of matter in the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to report such matter. Under clause (h) of sub-section (3) of section 143 of the Act, the auditor is required to state whether any matter leading to a qualification, reservation or adverse remark, that is, effectively the modification of the auditor's

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<sup>1</sup> Refer Rule 11 of Companies (Audit and Auditors) Rules, 2014.

<sup>2</sup> Reference may be made to Standard on Auditing (SA) 705, "Modifications to the Opinion in the Independent Auditor's Report."

<sup>3</sup> Reference may be made to paragraphs 6 and 7 of Standard on Auditing (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report."

report on financial statements, relates to the maintenance of accounts and other matters connected therewith.

### Reporting under Section 143(3)(f) of the Act

3. The relevant extracts of section 143(3)(f) of the Act are reproduced below:

“(3). *The auditor’s report shall also state –*

.....

*(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;”*

4. Clause (f) requires the auditor to report “the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company”. An auditor’s report may contain matters leading to modifications to the auditor’s opinion or emphasis of matter in the auditor’s report on the financial statements. Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words “observations” or “comments” as appearing in clause (f) of section 143(3) are construed to have the same meaning as referring to “emphasis of matter paragraphs, situations leading to modification in the auditor’s report. Accordingly, the auditor should have made an “observation” or “comment” in the auditor’s report in order to determine the need to report under clause (f) of section 143(3). Therefore, only such “observations” or “comments” of the auditors on financial transactions or matters that have been made by the auditor in the auditor’s report which have an adverse effect on the functioning of the company are required to be reported under this clause. For the sake of clarity, it may be noted that neither the auditor’s observations nor the comments made by him have any adverse effect on the functioning of a company. These observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.
5. The Act does not specify the meaning of the phrase ‘adverse effect on the functioning of the company’. The expression should not be interpreted to mean that any event affecting the functioning of the company, observed by the auditor, should be reported upon even though it does not affect the financial statements, e.g., revocation of a license to manufacture one out of the many products during the year to which the financial statements relate, where such product that does not have any material contribution to the revenues of the company, etc. Such an interpretation would not only be beyond the scope of the audit of financial statements of the company but would also not be in accordance with the objective and concept of audit stipulated under the Act. A more logical and harmonious interpretation is that this reporting requirement does not intend to change the basic objective and the

concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.

6. The scope of the audit and auditor's role remains as contemplated under the Standards on Auditing (SAs) and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200, *Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Standards of Auditing*, specifies that the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form the opinion of the true and fair view of the financial position and operating result of an enterprise. The auditor's opinion, therefore, does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. SAs require auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. At this juncture, it may also be noted that SA 200 also clearly states 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.
7. There is no change in the objective and scope of an audit of financial statements because of inclusion of clause (f) in sub-section (3) of section 143 of the Act. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate the subject matters leading to modification of the audit report or emphasis of matter in the auditor's report to make judgement as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters which, in the opinion of the auditor, have an adverse effect on the functioning of the company should be reported under this clause. Conversely, such qualifications or adverse opinions or disclaimer of opinion or emphasis of

matters of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be reported under this clause.

8. As far as inquiries under section 143(1) are concerned, the auditor is not required to report on these matters unless he has any comments to make on any of the items referred to therein. If the auditor has any comments or observations on any of the matters stated in section 143(1), the auditor should consider such comments or observations when reporting under this clause if they contain matters that may have any adverse effect on the functioning of the company.
9. Auditor's will need to apply professional judgement in considering matters of emphasis that may have an adverse effect on the functioning of the company. Ordinarily matters that are pervasive in nature such as going concern or matters that will significantly impact the operations of the company due to its size and nature will need to be reported under clause (f) of sub-section (3) of section 143 of the Act. Examples of emphasis of matter which may have an adverse effect on the functioning of the company include situations where:
  - the going concern assumption is appropriate but there are several factors leading to a material uncertainty that may cast a significant doubt about the Company's ability to continue as a going concern; or
  - a material uncertainty regarding the outcome of a litigation wherein an unfavourable decision could result in a significant outflow of resources for the company, etc.

Examples of emphasis of matter which may not have an adverse effect on the functioning of the company include a situation where there is an emphasis of matter:

- on managerial remuneration which is subject to the approval of the Central Government;
  - relating to accrual of a contractually receivable claim based on management estimate where the ultimate realisation could be different from the amount accrued;
  - on frauds that have been dealt with in the financial statements of the company and would not have any continuing effect on the financial statements.
10. Another issue which arises is whether any observations or comments made by the auditor under clause (i) of section 143(3) in respect of the company's internal financial controls over financial reporting, which may have any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that reporting under section 143(3)(i) is part of the auditor's report though it may be reported in an annexure to the auditor's report. Accordingly, if any observations or comments made by the auditor on the adequacy or operating effectiveness of internal financial controls over financial reporting contain such

matters, which, in his opinion, may have any adverse effect on the functioning of the company, should also be reported under clause (f) of section 143(3) even if such observation did not result in a modification to the audit opinion on the financial statements of the company. An example in this regard may be where an auditor reports that the company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification.

### **Reporting under Section 143(3)(h) of the Act**

11. The relevant extracts of section 143(3)(h) of the Act are reproduced below:

“(3). *The auditor’s report shall also state –*

.....

*(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;”*

12. Clause (h) requires the auditor to report “any qualification, reservation or adverse remark” relating to the maintenance of accounts and other matters connected therewith. An auditor’s report may contain matters leading to modifications in the auditor’s report on financial statements. The matters that cause such modification may have a consequential effects or possible effects on the books of account maintained by the company and other matters connected therewith.

13. Section 128 of the Act, *inter alia*, states that every company shall prepare and keep its books of account and other relevant books and papers and financial statements that give a true and fair view of the state of affairs of the company. Section 129(1) of the Act, *inter alia*, states that the financial statements shall comply with the accounting standards notified under section 133 of the Act. Section 2(13) of the Act defines “books of account” to include records maintained in respect of—

- (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
- (ii) all sales and purchases of goods and services by the company;
- (iii) the assets and liabilities of the company; and
- (iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section;

Clause (b) of section 143(3) requires the auditor to, *inter alia*, state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books.

14. Matters to be reported under clause (h) of section 143(3) needs to be evaluated based on the financial statements prepared under the Act. This is also consistent with the other reporting responsibilities of the auditor on books of account and

compliance with notified/specified accounting standards that are reported by him under section 143(3). Accordingly, reporting under this clause is determined based on the financial statements prepared i.e., as at the balance sheet date.

15. The words "qualification", "adverse remark" and "reservation" used in clause (h) of section 143(3) should be considered to be similar to the terms "qualified opinion", "adverse opinion" and "disclaimer of opinion", respectively, referred to in SA 705 "Modifications to the Opinion in the Independent Auditor's Report".
16. Accordingly, the auditor would need to report under clause (h) of section 143(3) any matter that causes a qualification, adverse remark or disclaimer of opinion on the financial statements since such matters will or possibly will have an effect on the books of account maintained by the company.
17. Further, reporting under clause (h) of section 143(3) will be required if the auditor makes any observation under clause (b) of section 143(3) relating to whether proper books of account as required by law have been kept by the company. For example, the auditor may have made an observation on maintenance of cost records under clause (b) of section 143(3) and this may not have had an effect on the financial statements of the company or the auditor's opinion on the financial statements.
18. As a corollary, reporting under clause (h) of section 143(3) will not be required if there are no modifications, i.e., no qualified, adverse or disclaimer of opinion, and there are no such observations under clause (b) of section 143(3) regarding books of account kept by the company.
19. Since clause (h) of section 143(3) requires the auditor to report under this clause only if the auditor has "any qualification, reservation or adverse remark", it is appropriate to conclude that a matter reported under emphasis of matter paragraph in the audit report need not be considered for reporting under this clause as an emphasis of matter is not in the nature of a qualification, reservation (disclaimer) or adverse remark.
20. Any material weakness in internal financial controls that is reported by the auditor under clause (i) of section 143(3) may not have an impact on the maintenance of books of account if such material weakness did not result in a modification to the opinion on the financial statements of the company. However, if the material weakness in internal financial controls resulted in a modification to the audit opinion on the financial statements, then such modification may be covered for reporting under clause (h) of section 143(3) as stated in paragraph 17 above.
21. The Appendix to this Guidance Note contains illustrations on matters that may give rise to reporting under section 143(3)(f) and/or section 143(3)(h) of the Companies Act, 2013.

## APPENDIX

### Illustrative Matters Forming Basis For Modified Opinion Or Emphasis Of Matter Paragraph in the Auditor's Report and Requiring Reporting Under Section 143(3)(f) and/or Section 143(3)(h) of the Companies Act, 2013

#### ILLUSTRATION 1

##### Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at ₹ XXX (As at 31st March 20YY: ₹ YYY). The Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standard - 2 "Valuation of Inventories". The Company's records indicate that had the Management stated the inventories at the lower of cost and net realisable value, an amount of ₹ XXX (As at 31st March 20YY: ₹ YYY) would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by ₹ XXX (Previous year ended 31st March, 20YY: ₹ YYY), and income tax, profit for the year and shareholders' funds would have been reduced by ₹ X, ₹ XX and ₹ XXX, respectively (Previous year ended 31st March, 20YY: ₹ Y, ₹ YY and ₹ YYY, respectively). This matter was also qualified in our report/ the report of the predecessor auditors on the financial statements for the year ended 31st March 20YY.<sup>4</sup>

##### Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph above, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31<sup>st</sup> March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

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##### Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

<sup>4</sup> Where applicable and only in such case, disclosure of previous year figures is required - Attention of the readers is drawn to the provisions of Standard on Auditing (SA) 710, *Comparative Information—Corresponding Figures And Comparative Financial Statements* .

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;  
 .....  
 .....
- (f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.  
 .....  
 .....
- (h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above."

### ILLUSTRATION 2<sup>#</sup>

#### Opinion

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31<sup>st</sup> March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

#### Emphasis of Matters

We draw attention to the following matters in the Notes to the financial statements:

- (a) Note X to the financial statements which, describes the uncertainty related to the outcome of the lawsuit filed against the Company by XYZ Company.
- (b) Note Y in the financial statements which indicates that the Company has accumulated losses and its net worth has been fully / substantially eroded, the Company has incurred a net loss/net cash loss during the current and previous year(s) and, the Company's current liabilities exceeded its current assets as at the balance sheet date. These conditions, along with other matters set forth in Note Y, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern. However, the financial statements of the Company have been prepared on a going concern basis for the reasons stated in the said Note.

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<sup>#</sup> In this case there is nothing reportable under sec 143(3)(h).

Our opinion is not modified in respect of these matters.

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#### **Report on Other Legal and Regulatory Requirements**

As required by Section 143 (3) of the Act, we report that:

.....

- (f) The going concern matter described in sub-paragraph (b) under the Emphasis of Matters paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

#### **ILLUSTRATION 3**

#### **Basis for Qualified Opinion**

ABC Company Limited's investment in XYZ Company, a foreign associate whose net worth has been fully/substantially eroded, is carried at ₹ XXX in the Balance Sheet as at March 31, 20XX. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited's investment in XYZ Company as at March 31, 20XX because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

#### **Qualified Opinion**

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects<sup>5</sup> of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31<sup>st</sup> March 20XX, and its profit/loss and its cash flows for the year ended on that date.

#### **Report on Other Legal and Regulatory Requirements**

As required by section 143 (3) of the Act, we report that:

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.....

- (f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

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<sup>5</sup> Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

- (h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.

#### ILLUSTRATION 4

##### Basis for Adverse Opinion

The Company's financing arrangements expired and the amount outstanding was payable on March 31, 20XX. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and, therefore, it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

##### Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 2013 in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31<sup>st</sup> March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

##### Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

- (f) The matter described in the Basis for Adverse Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

- (h) The adverse remarks relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Adverse Opinion paragraph above.

#### ILLUSTRATION 5

##### Basis for Disclaimer of Opinion

We were appointed as auditors of the Company after March 31, 20X1 and thus could not observe the counting of physical inventories at the beginning and end of the year. Accordingly, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and March 31, 20X1 which are stated in the Balance Sheet at ₹ XXX and ₹ XXX, respectively.

In addition, the introduction of a new computerised accounts receivable system in September 20X0 resulted in numerous errors in accounts receivable. As of the date of our audit report, Management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of ₹ XXX as at March 31, 20X1.

As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable in the Balance Sheet, and the corresponding elements making up the Statement of Profit and Loss and Cash Flow Statement.

### Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

### Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

.....

.....

(f) The matter described in the Basis for Disclaimer of Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The reservation relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Disclaimer of Opinion paragraph above.

## PART – II: QUESTIONS AND ANSWERS

### QUESTIONS

1. State with reason (in short) whether the following statements are true or false.
  - (i) SA-700 deals with modification to the opinion in the Independent Auditor's Report.
  - (ii) Guidance Notes are mandatory in nature.
  - (iii) As per SA-240, misstatements in the financial statements can arise from fraud only.
  - (iv) Misappropriation of assets can be accomplished by embezzling receipts only.
  - (v) The primary responsibility for the prevention and detection of fraud rests with the auditor.

- (vi) Inspection consists of looking at a process or procedure being performed by others.
- (vii) Audit note book constitutes the basic record for the auditor in respect of audit carried out by him.
- (viii) Purchase invoice is an example of internal evidence.
- (ix) The audit engagement letter is sent by the client to auditor.
- (x) Sufficiency is the measure of the quality of audit evidence.
- (xi) Risk of material misstatement may be defined as the risk that the financial statements are materially misstated subsequent to audit.
- (xii) Substantive procedure may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the assertion level.

### **Nature of Auditing**

2.
  - (a) "Doing a statutory audit is full of risk". Narrate the factors which cause the risk.
  - (b) "The auditors should consider the effect of subsequent events on the financial statements and on auditor's report". Comment with reference to SA 560.
3.
  - (a) "Discipline of statistics and mathematics has come quite close to auditing" Explain.
  - (b) "The process of auditing is such that it suffers from certain limitations" Discuss.
4. Discuss the following:
  - (a) With reference of SA 250 give some examples or matters indicating to the auditor about non compliance of laws & regulations by management.
  - (b) With reference to SA 530, meaning of audit sampling and requirements relating to sample design, sample size & selection of items for testing.

### **Basic Concepts in Auditing**

5.
  - (a) State the factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures.
  - (b) "External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items." Explain.
6.
  - (a) How would you proceed to check the misappropriation of cash in a trading concern?
  - (b) State any six areas in which different accounting policies may be encountered.
7.
  - (a) "Accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement". Discuss explaining the accounting estimates according to SA-540.
  - (b) Explain concept of 'Materiality'.

**Preparation for an Audit**

8. (a) "In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples needs to be followed". Comment.  
(b) "An audit programme is a detailed plan of applying the audit procedure in the given circumstance for accomplishing the audit objectives". Discuss.
9. (a) Discuss the factors the auditor will consider while establishing the overall strategy.  
(b) State the precaution to be taken in adopting test checking techniques.

**Internal Control**

10. (a) Explain the concept of Internal Control. Also state the objectives of Internal Control.  
(b) "Satisfactory Control Environment may help reduce the risk of fraud but is not an absolute deterrent for fraud". Explain.
11. (a) What is check list? Give few examples of check list instruction.  
(b) Discuss the circumstances where auditing through the Computer must be used.
12. (a) Explain clearly the meaning of Internal Check. Also state general consideration in framing a system of internal check.  
(b) Explain the activities of the Internal Audit function.

**Vouching & Verification of Assets and Liabilities**

13. (a) Describe how the payments from petty cash should be verified.  
(b) Define vouching. Also discuss the essential points to be borne in mind while examining a voucher.
14. How would you vouch/verify the following:
  - (a) Cash Sales
  - (b) Receipt from Account Receivable
  - (c) Consignment Sales
  - (d) Customs & Excise Duties
  - (e) Travelling Expenses
  - (f) Repairs to Assets
15. (a) Discuss the special precautions in verification of purchase invoice.  
(b) Explain the steps involved in carrying out the audit of ledgers.

**Company Audit**

16. Comment on the following:
- (a) An auditor purchased goods worth ₹ 510,200 on credit from a company being audited by him. The company allowed him one month's credit, which it normally allowed to all known customers.
  - (b) Mr. A, a chartered accountant has been appointed as auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2015. Subsequently in January, 2016 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.
  - (c) Due to the resignation of the existing auditor(s), the Board of directors of X Ltd. appointed CA. Hari as the auditor. Is the appointment of Hari as auditor valid?
17. Explain the following:
- (a) Appointment of First Auditor of a Non-Government Company.
  - (b) Appointment of First Auditor of a Government Company.
  - (c) Appointment of Subsequent Auditor of a Non-Government Company.
  - (d) Appointment of Subsequent Auditor of a Government Company.
18. (a) Discuss the audit procedure for verification of payment of dividends.
- (b) ABC Ltd. issued shares to its equity shareholders in the proportion of one bonus share for every four existing shares. As an auditor of the company, how would you verify this issue?

**Special Audits**

19. (a) An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:
- (i) Audit against Rules and Orders
  - (ii) Audit of Sanctions
  - (iii) Audit against Provision of Funds
  - (iv) Propriety Audit
  - (v) Performance Audit.
- (b) What role is played by Comptroller and Auditor General of India in the audit of a Government company?
20. What are the special audit points to be considered by the auditor during the audit of a Hospital?

**SUGGESTED ANSWERS / HINTS**

1. (i) **Incorrect:** SA 700 deal with forming an opinion and reporting of financial statement whereas SA 705 deals with modifications to the opinion in the Independent Auditor's Report.
- (ii) **Incorrect:** 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature.
- (iii) **Incorrect:** As per SA 240, misstatements in the financial statements can arise from either fraud or error.
- (iv) **Incorrect:** Misappropriation of assets can be accomplished in a variety of ways including embezzling receipts, stealing physicals assets etc.
- (v) **Incorrect:** As per SA-240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.
- (vi) **Incorrect:** Observation consists of looking at a process or procedure being performed by others.
- (vii) **Incorrect:** Audit working papers constitute the basic record for the auditor in respect of the audit carried out by him.
- (viii) **Incorrect:** External evidence is the evidence that originates outside the client's Organisation, e.g. Purchase Invoice, Debit Note, Credit Note etc.
- (ix) **Incorrect:** The Audit engagement letter is sent by the auditor to his client.
- (x) **Incorrect:** Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriation is the measure of the quality of audit evidence.
- (xi) **Incorrect:** Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit.
- (xii) **Incorrect:** Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
- Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:
- (i) Tests of details (of classes of transactions, account balances, and disclosures), and
- (ii) Substantive analytical procedures.

2. (a) **Factors Causing Risk Under Statutory Audit:** As Per SA 200 “Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing”, the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

An independent audit whether performed in terms of applicable financial reporting framework or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgements made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks.

**Factors which may cause such risk in conducting an audit are discussed below-**

- (i) **Exercising judgement on the part of the auditor:** The auditor’s work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.
- (ii) **Nature of audit evidence:** Much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such an evidence may far exceed the benefits.
- (iii) **Inherent limitations of internal control:** Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite clear that an audit suffers from control risk on account of inherent limitations of internal control and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies.

- (b) **Effect of Subsequent Events:** SA 560 “Subsequent Events”, establishes standards on the auditor’s responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events. The auditor should-

- (i) obtain an understanding of any procedures management has established to ensure that subsequent events are identified.
- (ii) inquire of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
  - Whether sales or acquisitions of assets have occurred or are planned.
  - Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
  - Whether there have been any developments regarding contingencies.
  - Whether there have been any developments regarding risk areas and contingencies.
  - Whether any unusual accounting adjustments have been made or are contemplated.
  - Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
  - Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
  - Whether any events have occurred that are relevant to the recoverability of assets.
- (iii) Read minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

- (iv) Read the entity's latest subsequent interim financial statements, if any.
- (v) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
- (vi) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.
- (vii) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.

3. (a) **Auditing and Statistics & Mathematics:** With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.
- (b) **Inherent Limitations of Audit:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from-
- (i) **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.

- (ii) **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:
- (1) There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
  - (2) Fraud may involve sophisticated and carefully organised schemes designed to conceal it. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
  - (3) An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.
- (iii) **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** The relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.
- (iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:
- Fraud, particularly fraud involving senior management or collusion.
  - The existence and completeness of related party relationships and transactions.
  - The occurrence of non-compliance with laws and regulations.
  - Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

4. (a) **Non-compliance of Laws and Regulations by Management:** As per SA 250 on "Consideration of Laws and Regulation in an Audit of Financial Statements", the following are examples or matters indicating to the auditor about non-compliance with laws and regulations by management:
- (i) Investigations by regulatory organisations and government departments or

payment of fines or penalties.

- (ii) Payments for unspecified services or loans to consultants, related parties, employees or government employees.
  - (iii) Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
  - (iv) Purchasing at prices significantly above or below market price.
  - (v) Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
  - (vi) Unusual payments towards legal and retainership fees.
  - (vii) Unusual transactions with companies registered in tax havens.
  - (viii) Payments for goods or services made other than to the country from which the goods or services originated.
  - (ix) Payments without proper exchange control documentation.
  - (x) Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
  - (xi) Unauthorised transactions or improperly recorded transactions.
  - (xii) Adverse media comment.
- (b) **Audit Sampling:** As per SA 530 on "Audit Sampling", the meaning of the term "Audit Sampling" is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

According to the said SA, requirements relating to sample design, sample size and selection of items for testing are explained below -

**Sample Design** - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

**Sample Size** - The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

**Selection of Items for Testing** - The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

5. (a) **Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:**
- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite

knowledge about the information being confirmed.

- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
  - ◆ May not accept responsibility for responding to a confirmation request;
  - ◆ May consider responding too costly or time consuming;
  - ◆ May have concerns about the potential legal liability resulting from responding;
  - ◆ May account for transactions in different currencies; or
  - ◆ May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.
- (b) **External Confirmation:** External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:
- Bank balances and other information relevant to banking relationships.
  - Accounts receivable balances and terms.
  - Inventories held by third parties at bonded warehouses for processing or on consignment.
  - Property title deeds held by lawyers or financiers for safe custody or as security.
  - Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
  - Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
  - Accounts payable balances and terms.

6. (a) **Steps to check Misappropriation of Cash:** Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc.

The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for.

It is, therefore, the duty of the auditors to see that in the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the foregoing.

Some of the methods through which cash may be misappropriated include-

- (a) Omission cash receipts:
  - (i) cash sales not recorded;
  - (ii) teeming and lading;
  - (iii) casual receipts of miscellaneous nature not entered; and
  - (iv) sale proceeds of fully written off assets not recorded.
- (b) Recording of less amounts than that actually received.
- (c) Recording of more amounts than that actually expended, e.g., discounts or rebates not taken into account while making payments, etc. Inclusion of fictitious payments in cash book e.g. wages paid to 'ghost' or 'dummy' workers, salary paid to apprentices whose tenure of services expired, etc.
- (d) Intentional errors in totaling, balancing and carrying over of cash book balances.

With a view to check misappropriation of cash, the existence of internal check system is quite essential. In particular, the following may be noted -

- (i) Ascertaining the existence of system of cash receipts and disbursements of cash sales and purchases and existence of internal checks at various stages is quite important. In particular, the separation of duties and incompatible functions, e.g., an employee who receives and deposits cash and cheques should not prepare sales invoices, or reconcile bank accounts, and authorised signatory should not approve vouchers for payment.
- (ii) Checking of cash receipts with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by itself would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of

each amount collected and the one or more receipts forms, thus saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as evidence of the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated.

- (iii) Checking of date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.
  - (iv) Verify cash sales with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof, as entered in the Cash Book.
  - (v) Check receipt of cash from the customers against price of goods sold with the counterfoils of receipt issued to them. Also compare entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a *prima facie* evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in customers' accounts, which ought to have collected in whole, are cleared in small instalments.
- (b) **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) Valuation of inventories – FIFO, LIFO, weighted average etc.
  - (iii) Treatment of goodwill – write off, retain.
  - (iv) Valuation of investment – at cost, market or net realizable value etc.
  - (v) Treatment of retirement benefits – actuarial, funded through trust, insurance policy etc.
  - (vi) Valuation of fixed assets – historical cost, revaluation price, exchange fluctuation etc.
- (Note: The above list is not exhaustive. There may be other examples as well.)

7. (a) **Accounting Estimates:** According to the SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure", accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. SA 540 addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific.

Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.

Additional examples of accounting estimates are:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.

- Outcome of long term contracts.
  - Financial Obligations / Costs arising from litigation settlements and judgments.
- (b) **Concept of Materiality:** According to SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
  - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both; and
  - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
- (1) Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred above provides the auditor with such a frame of reference.
  - (2) The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:
    - (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
    - (b) Understand that financial statements are prepared, presented and audited to levels of materiality;
    - (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

- (d) Make reasonable economic decisions on the basis of the information in the financial statements.
- (3) The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.
8. (a) **Selection of Audit Sample:** Audit Sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population.

The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.

Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample.

In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias.

Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.

- (b) **Audit Programme:** An audit programme is a detailed plan of applying the audit procedure in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. It is framed keeping in view the nature, size and composition of the business, dependability of the internal control and the given scope of work. Audit programme provides sufficient details to serve as a set of instructions to the audit team and also helps to control the proper execution of the work. On the basis of experience while carrying out the audit work, the programme may be altered to take care of situations which were left out originally, but found relevant for the particular audit situation. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, that may be dropped. There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. For the purpose of framing an audit programme the following points should be kept in view:

- Audit objective

- Audit procedure to be applied
- Extent of check
- Timing of check
- Allocation of work amongst the team members
- Special instructions based on past experience of the auditee.

9. (a) **In establishing the overall audit strategy, the auditor shall:**

- (i) Identify the characteristics of the engagement that define its scope;
- (ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- (iii) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- (iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- (v) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

- (b) **Precautions to be taken in Adopting Test Checking Techniques:** Generally, a large manufacturing concern is associated with a large volume of transactions. Also, the nature of the transactions is determined by the nature of the business. For example, one may find numerous purchases of raw materials, stores, spares, etc. there may be thousands of workers to be paid wages on weekly basis; the wages again may be calculated on a job or time basis. Depending upon the product lines, the sales mechanics may be different for different products - some may be to dealers and agents, some to wholesalers and some others even to retailers and consumers directly. Sales and purchase operations may stretch even to overseas markets. There may be various forms in which such a concern can raise bank finance, like letter of credit, packing credit, overdraft, bills discounted, etc. Basically, in a large manufacturing concern the problem is the problem of volume and variety.

In the circumstances when necessarily the test check technique has got to be adopted for audit work, it should be done by taking certain precautions so that a reliable idea about the truth and fairness of the accounts can be obtained by the auditor.

**The precautions that should be taken may be the following:**

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

- (ii) Systems and procedures for entering into and processing a transaction right from the beginning to the end should be studied in a sequential order. It involves questions of authorisations, documentation and recording and evidencing the same.
- (iii) The whole of the system of internal control in the 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. If, and only if, the auditor is satisfied about soundness of the controls and their operation in actuality, can he decide to have test checks. For testing the operation of the control system, 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, each voucher may be checked by the test check method for a number of objectives - one may be to ensure that the cash payments are properly authorised and acknowledged, others may be to see whether the amount actually payable has in fact been paid and whether the payment has been debited to the proper account. If there is a mix-up in the objectives or the objective is to 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 each test-check plan should be selected in a manner so that bias cannot enter in the selection. For the 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 predetermined. This can be done by deciding upon the degree of reliance that should be placed on the test-check result and the confidence that can be placed - the result 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) Errors that may be found may be material or immaterial in the context of the particular audit. Since errors of immaterial nature are not likely to distort the overall truth and fairness of the accounts, it is necessary to decide upon the

criteria to judge what constitutes a material error. Further investigation of immaterial error may be avoided and only the material errors may be properly and thoroughly investigated.

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

**Objectives of Internal Control:**

- (i) transactions are executed in accordance with managements general or specific authorization;
  - (ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
  - (iii) assets are safeguarded from unauthorised access, use or disposition; and
  - (iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.
- (b) **Satisfactory Control Environment - not an absolute deterrent to fraud:** The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

11. (a) **A Check List:** This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable. This is again an on the job requirement and instructions are framed having regard to the desirable elements of control. A few examples of check list instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?
5. Are the inventory control accounts maintained by persons who have nothing to do with:
  - (i) custody of work;
  - (ii) receipt of inventory;
  - (iii) inspection of inventory; and
  - (iv) purchase of inventory?

The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

(b) **Auditing through the Computer:** The auditor can use the computer to test: (a) the logic and controls existing within the system and (b) the records produced by the system. Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

There are several circumstances where auditing through the computer must be used:

- (1) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.
- (2) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.
- (3) The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.
- (4) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

The primary advantage of this approach is that the auditor has increased power to effectively test a computer system. The range and capability of tests that can be performed increases and the auditor acquires greater confidence that data processing is correct. By examining the system's processing the auditor also can assess the system's ability to cope with environment change.

The primary disadvantages of the approach are the high costs sometimes involved and the need for extensive technical expertise when systems are complex. However, these disadvantages are really spurious if auditing through the computer is the only viable method of carrying out the audit.

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

- (i) Existence of checks on the day-to-day transaction.
- (ii) Which operate continuously as a part of the routine system.
- (iii) Whereby the work of each person is either proved independently or is made complementary to the work of another.

Its objective is to prevent and to bring about a speedy detection of frauds, wastes and errors. The system is based on the principle that when the performance of each individual in an organisation, normally and automatically, is checked by another, the chances of occurrence of errors, or their remaining undetected, are greatly reduced; also that, when two or more persons essentially must combine either to receive or to make a payment, there will be lesser possibility of a fraud being perpetrated by them.

For instance, let us consider the simple case of a trading concern. It would have a cashier to receive cash who also shall issue receipts. There would be separate persons to write the cash book and ledgers, the stores accounts would be maintained by the store-keeper, and so on; there would be thus a large number of functionaries. In such an organisation, for putting through a transaction of sale, first of all a bill would be prepared and the same would be checked and authorised by the sales manager; afterwards the cashier would collect the sale price and finally

the store-keeper would issue the goods, on being satisfied that each of the functionaries earlier to him had carried out his part of duties.

Such a division of responsibilities is made on the broad principle that persons having physical custody of assets should not have access to the books of account. Also apart from accounting control, the physical and financial records of important assets should be reconciled periodically.

The scope of the statutory or professional audit is limited by the both the cost and the time factors. Therefore, it is increasingly being recognised that for an audit to be effective, especially when the size of a concern is large, the existence of a system of internal check is essential. The auditor can rely on it and, on that consideration, reduce the extent of detailed checking to be carried out by him but only after he has checked its effectiveness by the application of procedural tests. It must, however, be added that in the event of any mistake or fraud being discovered subsequently in the area of accounts which the statutory auditor has accepted to be correct, he may be guilty of negligence regardless of the fact that he had tested the internal check in operation before he has accepted it to be correct.

#### **General Considerations in Framing a System of Internal Check:**

- (i) No single person should have an independent control over any important aspect of the business. All dealings and acts of every employee should, in the ordinary course, come under the review of another.
- (ii) The duties of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
- (iii) Every member of the staff should be encouraged to go on leave at least once in a year. Experience has shown that frauds successfully concealed by employees are often unearthed when they are on leave.
- (iv) Persons having physical custody of assets must not be permitted to have access to the books of account.
- (v) There should exist an accounting control in respect of each important class of assets; in addition, these should be periodically inspected so as to establish their physical condition.
- (vi) To prevent loss or misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.
- (vii) A majority of business concerns now-a-days work according to some kind of budgetary control. It enables them to review from time to time the progress of their trading activities. Such business houses should have a separate staff for the collection of statistical figures which later on should be checked with the corresponding figures from the financial books. If wide discrepancies are

observed, these should be reconciled.

- (viii) For inventory-taking, at the close of the year, trading activities should, if possible, be suspended. The task of inventory-taking, and evaluation should be done by staff belonging to several sections of the organisation. It may prove dangerous to depend exclusively on the inventory section staff for these tasks, since they may be tempted to under or over-state the inventory.
  - (ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.
  - (x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.
  - (xi) Accounting procedures should be reviewed periodically, for, even well-designed and carefully installed procedures, in course of time, cease to be effective.
- (b) **Internal Audit Function:** As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The activities of the internal audit function may include one or more of the following:
- **Monitoring of internal control.** The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
  - **Examination of financial and operating information.** The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
  - **Review of operating activities.** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.
  - **Review of compliance with laws and regulations.** The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.
  - **Risk management.** The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.

- **Governance.** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

13. (a) **Petty Cash:** Payments from petty cash should be verified as follows -
- (i) Trace the amounts advanced to the petty cashier for meeting petty office expenses from the Cash Book in the Petty Cash Book.
  - (ii) Vouch payments with docket vouchers which must be supported, wherever possible, by external evidence e.g., payee's receipted bill or invoices, cash memo, etc.
  - (iii) Trace payments made for the purchase of postage stamps recorded in the Postage Book. The totals of the Postage Book should be test checked. The amounts of postage stamps in hand, at the end of the year, should be credited to Postage Account by debiting the amounts to Postage in Hand Account. It should be seen that the amount paid for postage stamps is not unduly large and the Postage Book is normally checked by the petty cashier from time to time before the amount of imprest is reimbursed. Confirm that the postage expenses for the year are reasonable as compared with that in the postage expenses from month to month.
  - (iv) See where a columnar Petty Cash Book is maintained, that the extension have been carried forward into appropriate amount columns.
  - (v) Check the column totals and cross totals.
  - (vi) Trace posting of the various columns in which payments are classified to the respective ledger accounts.
  - (vii) Verify the cash balance in hand.
  - (viii) Auditor should also verify whether the amount of petty cash imprest is fixed. Is this amount reasonable considering the total amount of petty cash payments made during a month or so?
- (b) **Vouching:** The act of examining vouchers is referred to as vouching. It is the practice followed in an audit with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its

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

- (i) that the date of the voucher falls within the accounting period;
- (ii) that the voucher is made out in the client's name;
- (iii) that the voucher is duly authorised;
- (iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and
- (v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

14. (a) **Cash Sales:** Primarily, the system of internal check should be examined with the objective of finding out loopholes therein, if any, whereby cash sales could be misappropriated. Further, the practice followed in the manner cash memos are issued should be ascertained. Because in case, cash memos are issued not only for cash sales but also for credit sales, the amount whereof if collected long after, there would be no guarantee that all the amount of cash sales has been collected before the close of year or that some of the amounts collected have not been misappropriated.

Cash sales usually are verified with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof has been entered in the Cash Book.

To verify that price of goods sold has been calculated correctly; the computation of the sales should be ascertained. If a cash memo has been cancelled, its original copy should be inspected, for it could be that the amount thereof has been misappropriated.

- (b) **Receipts from Account Receivables:** Receipt of cash from the account receivables against price of goods sold are checked with the counterfoils of receipt issued to them. At the same time, it is also verified that there is a system of internal check in operation which acts as a safeguard against amounts collected being misappropriated.

One of the common devices for misappropriating cash collections from account receivables is the one known as Teeming and Lading. Such a fraud, usually, remains undetected for long since the cashier is able to make good the amounts misappropriated before the cash balance is checked. At times, the cashier who has committed such a fraud may cover up the amounts misappropriated, by raising a fictitious debit in an expense account.

When such a fraud is suspected, the first step in its investigation should be making comparison of the entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a *prima facie* evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in account receivables' accounts, which ought to have collected in whole, are cleared in small instalments.

If such evidence exists, the matter should be investigated further. This can be done by all the account receivables being requested to send statements of account from their books, for the period during which the fraud is suspected to have been in progress. On comparing items in each statement, with the entries in the account receivable's accounts, it would be possible to locate amounts which were not deposited on the day these were collected, but subsequently.

- (c) **Consignment Sale:** Where the number of consignments sent out in a year is large, usually a separate consignment Sales Day Book and Ledger are kept. In that case, the entries in the Day Book in respect of price of goods sent out and expenses incurred on their transport and insurance should be verified with copies of proforma invoices and other relevant documents; the sale price of goods sold and expenses incurred by the consignee should be verified from the Account Sales.

The balances in the Consignment Ledger, at the end of the year in such a case, would represent the cost of unsold goods, including a proportion of non-recurring expenses incurred on their transport and insurance. These balances should agree with those shown in the respective account sales received from the consignees.

If the goods sent out for sale on consignment have been charged at the invoice price, the difference between the cost and the invoice price would be credited to the Consignment Stock Adjustment Account. The appropriate part of the amount credited in this account attributable to the inventory remaining unsold at the year end, should be reversed so that credit can be taken for the net amount representing the difference for the part actually sold.

- (d) **Customs and Excise Duties:** The audit procedures for custom duties are listed below-
- (i) **Examine Cash Book:** Examine the payment of custom duties in the cash book

with reference to bill of entry.

(ii) **Examine the Bill of Entry:**

- ✓ Check the amount of custom duty was calculated correctly, i.e., in accordance with the applicable rate for dutiable goods.
- ✓ If the duty has been paid by dealing and forwarding agent, examine bill of entry with reference to agent's bill.
- ✓ If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of customs duty.

(iii) **Examine Disputed Cases Carefully:** In case of a dispute about the amount of duty payable, a provisional payment may have been made. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.

(iv) **Verify for Duty Drawback:** Duty drawback refers to a scheme under which central excise and customs duties paid for raw-materials and other inputs used in the manufacture of the product prior to its export are refunded to the exporter. The auditor should verify the claim of duty drawback with reference to acknowledgement issued by the Directorate of duty drawback.

Excise duty becomes payable at the time of releasing of excisable goods from the factory/godown to the manufacturer. Normally, the excise duty payable is deposited with the designated bank to the credit of the controller of excise and one copy of the challan is forwarded to him for obtaining the permit and another copy is sent to the dispatch department evidencing payment of required duty. The auditor may adopt the following procedures to vouch the payment of excise duties:

- (i) Verify payment of excise duties by examining the duty paid as per Challans with reference to the quantity of goods in respect of which issue permits have been received.
  - (ii) Test check the accuracy of the amount of duty paid by multiplying the rate of excise duty with the value of goods issued as per the client's inventory register.
  - (iii) In respect of excisable goods manufactured but remaining to be released, ensure that necessary provision for unpaid excise duty has been made.
  - (iv) Ensure that in every case CENVAT credit has been adjusted and only net excise duty has been paid.
- (e) **Travelling Expenses:** Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure

incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.

As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

The voucher for travelling expenses should normally contain the under mentioned information:

- (i) Name and designation of the person claiming the amount.
- (ii) Particulars of the journey.
- (iii) Amount of railway or air fare.
- (iv) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.
- (v) Other expenses claimed, e.g., portorage, tips, conveyance, etc.

If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source. Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified. The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board. The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.

Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

- (f) **Repairs to Assets:** Since the line demarcating repairs from renewals is slender, usually it is not a simple matter to determine the amount of the expenditure, if any, included as charges for repairs, which should be considered as that incurred for renewal of an asset and added to its cost. It may sometimes be possible to determine this on a consideration of the nature of repairs carried out. The proportion of the charges which had the effect of increasing the value of an asset or enhancing its capacity or life should be treated as capital expenditure. Where, however, it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be

obtained. It should be ensured that Repairs to 'Certain Assets' like Building and Machinery have been separately disclosed as per the requirements of Schedule III.

**15. (a) Special Precautions in Verification of Purchase Invoices:**

- (i) When an invoice runs into several pages and the total of each page has been carried forward to the next or where the amount of an invoice has been distributed over several accounts, it should be confirmed that the amounts relating to different parts of the invoice have been adjusted together. When the total amount of the invoice has been adjusted in separate accounts, the entire amount so adjusted should be added together to confirm that there has not been error under adjustment.
- (ii) At times, invoices are received in duplicate and even triplicate. In such cases, payment usually is made on the basis of the original invoice. Sometimes, however, the original is kept in record and the price is adjusted on the basis of the duplicate. In such a case, it should be confirmed that the original invoice has also been paid or adjusted separately.
- (iii) Often supplies are received on certain special conditions. In such cases, it should be verified that these are the same as were agreed to at the time the order was placed, *e.g.*, payment of freight and insurance charges of goods while in transit, etc. If the amount of an invoice was payable after the lapse of some time, subsequent to the receipt of goods, it should be ascertained that it has not been paid earlier and the benefit of cash discount, if any, has been obtained. Where a trade discount has been deducted from the amount of the invoice, it should be seen that only the net amount has been credited to the supplier.
- (iv) Where goods have been purchased for the use of an officer or a subordinate but the invoice is made out in the name of the concern for obtaining the benefit of trade discount, it should be seen that the cost has been charged to the person concerned and not to the Purchases Account.
- (v) Purchases of goods from the allied and associated concerns can be made only under an appropriate sanction.
- (vi) If the case of an invoice addressed to an individual, particular care should be taken when vouching such an item, since the individual may have attempted to procure goods for his own use while allowing the company to pay for them. The system of internal check for purchases should be such as to preclude such a possibility. Nevertheless, it should be seen whether the goods are of a type which the company usually requires, and whether the invoice has been duly checked by someone other than the individual to whom it was addressed.

The delivery note and the goods inward note should be examined and it should be seen that the goods were inspected on arrival. Further evidence should also

be sought to establish whether the goods were actually received into inventory. The original order for goods should have been duly authorised by a responsible official. The firm supplying the goods should be requested not to submit invoices addressed in this way.

- (vii) If materials are bought for delivery direct to a account receivable, the exact circumstances of the transaction should be ascertained and the reasons for the goods having been delivered direct to the account receivable. The auditor should make appropriate inquiries in order to establish that the transaction was appropriately authorised by a responsible official. A copy of the delivery note signed by the account receivable on delivery of the goods should be examined, and it should be ascertained whether the account receivable is a regular purchaser of the company's goods and not an employee of the company wishing to take advantage of a weakness in the system. The original order should also be seen to have duly authorised by the appropriate official, and if this practice is a regular feature of the company's mode of transacting business, the system of internal check should be such as to ensure that no fraud may be perpetrated as a result of this practice. The payment for the goods, if it has been received, should be vouched to the cash book and bank statement.
  - (viii) Though it is not practicable for an auditor to verify that every item of goods purchased has been entered in inventory, he should trace into the inventory record at least purchases of goods during the opening and closing months and accept the correctness of the rest only if he is satisfied that there exists a system of internal control which prevent payment being made for any goods not received in inventory.
- (b) **Audit of Ledgers - General Considerations:** The audit of ledgers generally involves the under mentioned steps -
- (i) Testing the strength and quantity of internal check;
  - (ii) Tracing the opening balances from the previous year's records;
  - (iii) Checking the postings from subsidiary books and, if they are kept on the self-balancing system, also tallying the totals of balances in subsidiary ledgers with those in the total of control account;
  - (iv) Checking the closing balances of individual accounts on the balance schedules afterwards from the schedules on to grouping schedules and then into the final accounts;
  - (v) Checking the totals of ledger accounts, trial balance, schedules and groupings;
  - (vi) Verifying the balances in personal accounts, either with the statements of account or confirmation of balances obtained from the parties; verifying the balances in impersonal accounts, viz., those of fixed assets, bank balances, etc. with the schedules containing details of assets and liabilities as well as

those of nominal accounts (featuring various items of income and expense by reference to the documentary evidence which may exist in a variety of forms to ensure that all the outstanding amounts, both receivable and payable have been properly adjusted);

- (vii) Scrutinizing the accounts generally and, in particular, examining the composition of final balances; and
- (viii) Ascertaining the extent of clearance of the balances brought forward from the previous year particularly those relating to receivables and payables, sale or disposal of fixed assets and of inventories.

The audit of ledgers is thus an important step in the process of verification of the correctness of Final Accounts. It is an occasion to review the transactions entered during an accounting period, duly classified, in the totality; also that of studying the relationship which exists between different sets of figures. Ledgers, therefore, should be examined carefully and comprehensively. The composition of the balance of each account should be scrutinised and, if a doubt arises, the transaction or the set of transactions, which have given rise to the doubt should be examined in depth.

When a comprehensive and effective system of internal control exists, it is possible to limit the routine checking of ledgers by the application of test checks as stated below:

- (i) verifying the postings into the ledgers from the various books of prime entry;
- (ii) verifying the totals of the account;
- (iii) tracing the balances of the personal and nominal accounts from the ledgers into the schedule of balances;
- (iv) comparing schedules totals with the balances in the Control Accounts; and
- (v) checking the position of the daily entries into Control Accounts.

The foregoing audit tests are applied to a selected group of entries in the ledgers. Alternatively, steps (i) to (iv) should be applied to accounts for parts of the year determined on a selection. However, the posting of the Control Accounts should be verified for the whole year. In selecting the period or periods of verification of posting and totals, preference should be given to the accounts the composition whereof is not clear or in which items on either side cannot be correlated. Moreover, instead of certain periods being selected for the application of test checks, a few accounts could be selected for being test checked for the whole of the year.

If, however, the system of internal control on application of procedural tests is found to be ineffective, it would be necessary for the auditor to extend the programme of verification of balances of the accounts in the ledgers as aforementioned. In doing so, the auditor should take into account the existence of possibilities of frauds being committed through manipulation of entries in the ledgers, for example, the

possibility of the ledger clerk colluding with others for misappropriating amounts collected from the account receivables and subsequently covering up misdeeds by adjusting fictitious credit in the account receivable accounts.

Such a fraud in a ledger would not be disclosed merely on extracting balances from the ledger and agreeing their totals with the balance in the respective Control Accounts, since the balances, despite the fraud, would agree. It would be discovered either on postings being checked in detail, or on obtaining detailed statements of account from account receivables and comparing them with those stated in the books of account.

16. (a) **Purchase of Goods on Credit by the Auditor:** Section 141(3)(d)(ii) of the Companies Act, 2013 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding five lakh rupees.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh, he is disqualified for appointment as an auditor of the company.

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

- (b) **Disqualifications of an Auditor:** Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor.

In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited, has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited.

- (c) **Board's Powers to Appoint an Auditor:** As per Section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

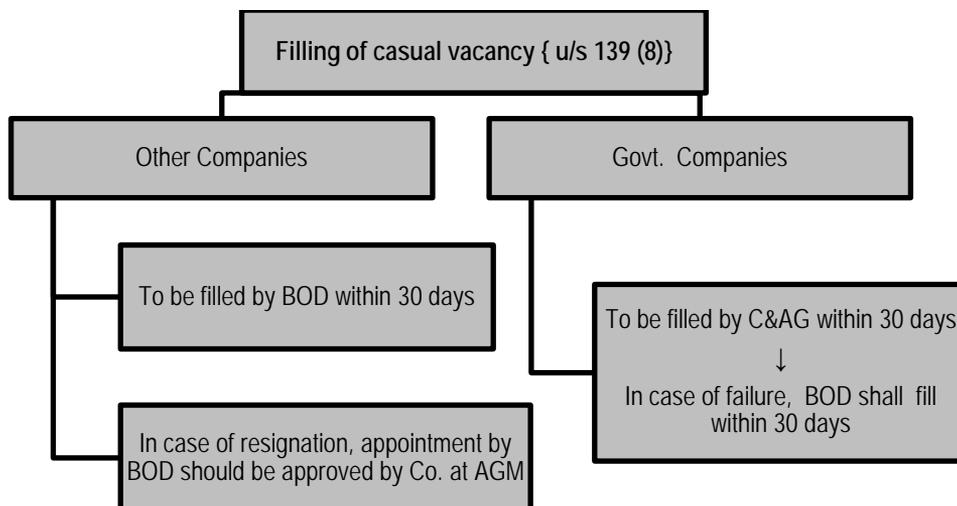
- (i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall

hold the office till the conclusion of the next annual general meeting;

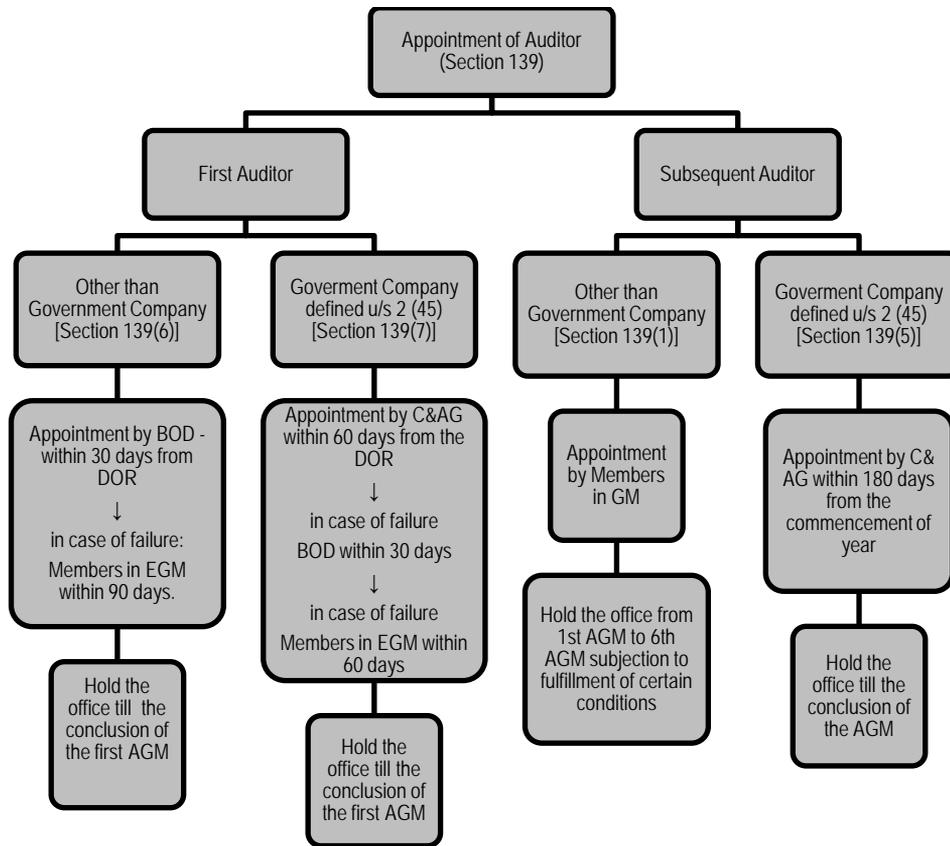
- (ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.



In the given case, the Board of directors of X Ltd. has appointed CA. Hari as the auditor due to resignation of the existing auditor(s). The appointment made by the Board is correct, however, such appointment should be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and newly appointed auditor shall hold office till the conclusion of the next annual general meeting.

17. **Appointment of Auditors:** Section 139 of the Companies Act, 2013 contains provisions regarding appointment of Auditors. Provisions related to appointment of auditors may be grouped under two broad headings-
- I Appointment of First Auditors.
  - II Appointment of Subsequent Auditors.



- (a) **Appointment of First Auditor of a Non-Government Company:** As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

- (b) **Appointment of First Auditor of a Government Company:** Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

- (c) **Appointment of Subsequent Auditor of a Non-Government Company:** As per section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.
  - (d) **Appointment of Subsequent Auditor of a Government Company:** As per Section 139(5) of the Companies Act, 2013, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.
18. (a) **Verification of Payment of Dividends:** The procedure for the verification of payment of dividends is stated below-
- (i) Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.
  - (ii) Confirm that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Section 123 of the Companies Act, 2013. If the company proposes to pay the dividend out of past profit in reserves, see that either this is in accordance with the rules framed by the Central Government in this behalf.
  - (iii) Inspect the Shareholders' Minute Book to verify the amount of dividend declared and confirm that the amount recommended by the directors.
  - (iv) If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.
  - (v) Check the particulars of members as are entered in the Dividend Register or Dividend List by reference to the Register of Members, test check the calculation of the gross amount of dividend payable to each shareholder on the basis of the

number of the shares held and the amount of CDT, if applicable. Verify the casts and crosscast of the different columns.

- (vi) Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in the Dividend Bank Account.
  - (vii) Examine the dividend warrants in respect of previous years, presented during the year for payment and verify that by their payment, any provision contained in the Articles in the matter of period of time during which amount of unclaimed dividend can be paid had not been contravened.
  - (viii) It is compulsory for a company to transfer the total amount of dividend which remains unpaid or unclaimed, within thirty days of the declaration of the dividend to a special bank account entitled "Unpaid Dividend Account". Such an account is to be opened only in a scheduled bank. The transfer must be made within 7 days from the date of expiry of thirty days.
  - (ix) In case any money transferred to the unpaid dividend amount of a company remain unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred to Investor Education and Protection Fund.
  - (x) Ensure the compliance, in case dividend is paid in case of inadequate profits.
- (b) Verification of Issue of Bonus Shares:** Section 63 of the Companies Act, 2013 allows a company to issue fully paid-up bonus shares to its members, in any manner whatsoever, out of-
- (i) its free reserves;
  - (ii) the securities premium account; or
  - (iii) the capital redemption reserve account.

The auditor should ensure that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Further, he should also ensure the compliance of condition for capitalization of profits or reserves for the issuing fully paid-up bonus shares like -

- (i) it is authorised by its articles;
- (ii) it has, on the recommendation of the Board, been authorised in the general meeting of the company;
- (iii) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
- (iv) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
- (v) the partly paid-up shares, if any outstanding on the date of allotment, are made

fully paid-up;

- (vi) it complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same;
- (vii) the bonus shares shall not be issued in lieu of dividend.

19. (a) **Government Expenditure Audit:** Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

- (i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.
- (ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.
- (iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.
- (iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.
- (v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

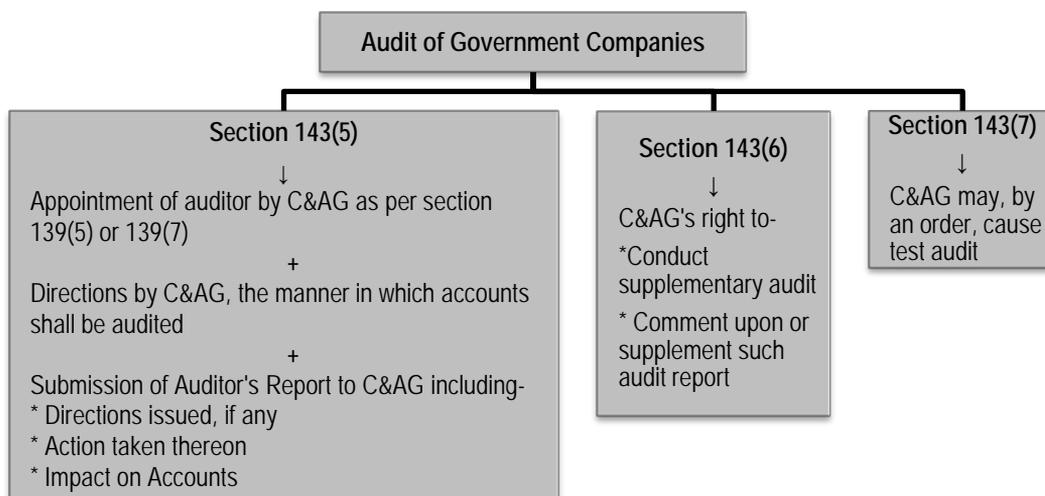
(b) **Role of C&AG in the Audit of a Government company:** Role of C&AG is prescribed under sub-section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to,

- (i) **conduct a supplementary audit** of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, 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 Comptroller and Auditor-General of India may direct; and
- (ii) **comment upon or supplement such audit report:** It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

**Test Audit:** Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.



20. **Audit of Hospital:** The audit points to be considered by the auditor during the audit of a Hospital are stated below -

- (i) **Income from Services:** 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) **Collection of Cash:** 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) **Income from Investments:** 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) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (v) **Reconciliation of Subscriptions:** 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) **Authorisation and Sanctions:** 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) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
- (viii) **Budgets:** 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) **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
- (x) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
- (xi) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
- (xii) **Inventories:** Obtain inventories, especially 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.
- (xiii) **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.