PAPER – 2 : AUDITING

QUESTIONS

1. Briefly explain - “Accounting Estimates”.
2. State briefly the qualities of Auditors.
3. What is compensating error?
4. What do you mean by the term Fraud? Briefly explain the various types of Fraud?
5. Distinguish between Internal Auditor and External Auditor.
6. Differentiate between “Persuasive Evidence” and “Conclusive Evidence”.
7. What is the relationship of Audit risk with materiality?
8. Briefly explain Representation by Management.
9. What do you understand by Audit through the Computer?
10. How will you vouch/verify the following ?
    (a) Goods sent on consignment
    (b) Receipt of capital subsidy
    (c) Provision for income tax
11. What is meant by Contingent Liability ?
12. Comment on the following:
    (a) In case the existing auditor(s) appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy.
    (b) A and Co., Chartered Accountants, who were appointed as the first auditors of the company, were removed without the prior approval of the Central Government, before the expiry of their term, by calling an Extraordinary General Meeting.
    (c) Due to the resignation of the existing auditor(s), the Board of directors of X Ltd appointed Mr. Sanjeeth as the auditor. Is the appointment of Sanjeeth as auditor valid?
    (d) At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?
13. As an Auditor, comment on the following situations/statements:
    (a) S Ltd. had a major break down in its plant in the month of January, 2008. In the month of March, 2008 it entered into an agreement with an engineering firm for the purpose of repairing its plant for a consideration of Rs. 150 lacs. The engineering firm started the repairing work in the month of April, 2008 and completed it in the same month. S Ltd. made the provision for said expenditure on repairs in its books of account for the financial year 2007-08 on the plea that the event of break down

leading to repair expenditure had taken place in the financial year 2007-08, binding contract for repairs was entered into during the financial year 2007-08 and repair work was also completed before the financial statements were approved by the Board of Directors of the company.

(b) The management tells you that WIP is not valued since it is difficult to know the same in view of multiple processes involved and in any case opening and closing WIP would be more or less the same.

14. Comment on the following:

(a) The auditor of a limited company has given a clean report on the financial statement on the basis of Xerox copies of the books of accounts, Vouchers and other records which were taken away by the Income-tax Department in search under section 132 of the I.T. Act, 1961.

(b) A and B were appointed as Joint Auditors of Ram and Som Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the notice of both the Auditors.

(c) Abhishek, a member of the ICAI, does not hold a Certificate of practice. Is his appointment as an auditor valid?

(d) 'M' owes Rs. 1200 to 'N' Ltd., of which he is an auditor. Is his appointment valid? Will it make any difference, if the advance is taken for meeting-out travelling expenses?

15. As an Auditor how would you react to the following situations/comments?

(a) In a company Fixed Assets have been revalued and there has been resulting surplus of Rs.1,50,000, which is transferred to revaluation reserve. The Company has a Debit balance in Profit and Loss account Rs.80,000 as accumulated brought forward losses. The company has adjusted this loss balance against revaluation reserve.

(b) The Central Government sanctioned Rs.15 lakhs as Grant to a Hospital for the purchase of certain equipments and paid Rs.10 lakh as advance. The hospital took Rs.8 lakhs as income in the Profit and Loss account for the year.

16. Write short notes on the following:

(a) Disclaimer of opinion.

(b) Process of Judgment formation by auditor.

17. Answer the following:

Jagan Ltd. installed a new water treatment plant at its factory on 1.10.2007. The company estimated that the new plant will become obsolete after 4 years only and hence charged depreciation at a rate higher than that envisaged in Schedule XIV to the Companies Act. During the year 2007-08, the company therefore, written off $1/4^{th}$ of the cost.

18. State the matters to be specified in the Auditor's report in terms of provisions of Section 227(3) of the Companies Act, 1956.

19. Write short notes on the following:

    (a) Cut-off arrangements.

    (b) Surprise checks.

20. Explain the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at Service Bureau.

21. As a Company auditor how would you react to the following situations?

    (a) A publishing company undertook repair and overhauling of its machinery at a cost of Rs.2.50 lakhs to maintain them in good condition and captialised the amount as it is more than 25% of the original cost of the machinery.

    (b) Interest on loan borrowed to purchase a machinery which has been installed two years back is still debited to machinery account.

    (c) Rs.5 Lakhs paid by a pharma company to the legal advisor defending the patent of a product treated as capital expenditure.

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

    (a) The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately.

    (b) The register of members of JK Ltd. has not been written up-to-date and as a result, the balances in the register do not agree with the amount of issued Share Capital.

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

    (b) What special steps will you take into consideration while auditing the receipts from entry fees of an amusement part? Mention any four points specific to the issue.

SUGGESTED ANSWERS/HINTS

1. Accounting Estimates: It means an approximation of the amount of an item in the absence of a precise means of measurement. Accounting estimates are made in conditions of uncertainty and involve the use of judgement. The use of reasonable estimates is an essential part of the preparation of financial statements. An

estimation requires revision when the circumstances on which the estimation was based got changed.

Estimation of accounting information is the responsibility of the management. The auditor has to asses reasonableness of accounting estimates made by the management. Following are some of the examples of accounting estimates:

(i) Allowances to reduce inventory and accounts receivables to their estimated realisable value.

(ii) Provision to allocate the cost of fixed assets over their estimated useful life – i.e. depreciation.

(iii) Accrued income.

(iv) Provision for taxation.

(v) Provision to meet warranty claims.

(vi) Provision for retirement benefits in the financial statements of employers.

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

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

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

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

3. Meaning: When errors counteract each other by the same amount, it is called compensating errors.

Nature: It is a technical error.

Types: It can be classified as under:

- Errors which do not affect profit: Profit will not be affected when both original and compensating error arise in revenue a/c.
- Errors which affect profit: If the original or compensating error arise in revenue account and other in an asset or liability account, Trial Balance will agree but profit will not show correct amount.
- Effect on Trial Balance: These errors do not affect Trial Balance.
- Effect on Profit: If the errors involve income and expenditure account, profit will not be affected. But if error is in asset & liability account only, it may not affect profit.

Detection: These errors are deliberately concealed and hence difficult to detect. But audit procedures like analytical review, ledger scrutiny etc. can partially help to locate these errors.

4. "Fraud" is an error which is done intentionally. It includes in it willful misrepresentation, the deliberate concealment of a material fact or the failure to disclose a material fact, for the purpose of inducing another person and putting him at a disadvantage. Frauds can be detected by due care and effort on the part of the auditor and by use of proper internal controls and checks instituted by the organisation.

According to SA 240 (Revised), fraud involves –

(i) A motivation to commit fraud; and

(ii) A perceived opportunity to do so.

Types:

Fraud can occur in any of the following forms –

1. Misappropriation of cash
2. Misappropriation of goods
3. Teeming and Lading
4. Manipulation of accounts and falsification of accounts
5. Window dressings.

1. Misappropriation of Cash: Misappropriation of cash can take place in following manner:

    (i) By acknowledging a lesser amount than actually received; or

    (ii) By omission of receipt; or

    (iii) By inclusion of fictitious payments; or

    (iv) By recording more payments than actually made.

    Examples:

    Non-recording of cash sales.

    Recording payments for fictitious purchases etc.

Detection: Frauds can be detected by careful comparison of records in the cash book with other subsidiary book and the original vouchers.

2. Misappropriation of goods: Chances of such fraud are greater in case of goods which are less bulky but more valuable.

   Example:

   Recording purchases of larger quantities than they one actually supplied and appropriating balance in each case for unlawful personal gain.

   Detection: Fraud of such nature can be detected by –

   (i) Proper maintenance of accounts as to purchase & sales

   (ii) Regular stocktaking

   (iii) Maintaining a periodic and strict check on incoming and outgoing goods.

3. Teeming and Lading: According to the method of "teeming and lading" money received from the customer may be pocketed and when money is received from the other customer that may be shown as received from the former customer. Such process may be continued for long and it may involve cash received from many customers.

4. Manipulation of accounts and falsification of accounts: Some methods of manipulating the accounts are as follows:

   (i) Omitting to record various expenses.

   (ii) Recording fictitious sales or purchases.

   (iii) Creation or utilization not secret reserves.

   (iv) Charging more or lesser amount of depreciation, overvaluation or undervaluation of the stock or other assets or liabilities.

   (v) Changing revenue expense as capital expense vice-versa.

   Object: The object of committing such frauds are –

   (i) To avoid incidence of income-tax or any other taxes;

   (ii) For declaring dividend in case of insufficient profits;

   (iii) To obtain more credit or more capital for the concern;

   (iv) To secure larger amount of commission due to themselves;

   (v) Generally such fraud is committed by persons holding high positions in the business setup.

5. Window – dressing: It implies the practice of arranging the disposition of assets and liabilities in such a way that affairs of the business as shown in the Balance Sheet does not show the normal financial position. It may represent the affairs of business more fovourable than they actually are. Window – dressing can be done in following ways:

   (i) Goods-in-transit shown as sales.

(ii) Recording of sales & income of the following year in current year.

(iii) Treatment of normal revenue expenditure as deferred revenue expenditure.

(iv) Recording gods sent on 'sale on return basis' as regular sales.

5. Distinguish between Internal Auditor and External Auditor

Point of Difference	Internal Auditors	External Auditors
Meaning	These auditors are internal to the organisation.	These auditors are external to the organization.
Status	An employee of the enterprise.	Wholly independent of the enterprise audited. Not an employee of the enterprise.
Scope of Work	The scope of work is determined by the management.	The scope of work is determined by statute (law).
Approach	Main concern is to ensure compliance with: (i) Policies, procedures, & rules of enterprise. (ii) Legal & government regulations. (iii) Generally accepted accounting principles.	Main concern is to collect adequate and reliable evidence to support his opinion regarding truth and fairness of the financial statements.
Appointment Accountability	Appointed by the management or persons directly responsible to the management.	Appointed by the owners (e.g. shareholders) or persons directly responsible to the owners.

6. Information on the basis of which the auditor forms and expresses his opinion is called an "evidence". It consists of information contained in the accounting records as well as other corroborating information obtained by auditor by audit techniques.

   By persuasive evidence, we mean that the auditor needs to obtain evidence of quality. It indicates that whatever management is asserting through accounting records and financial statements is most likely to be true than not.

   Evidence of such strength and quality that what management asserts is only true and any other possibility is totally ruled out is said to be conclusive evidence.

7. As per "SA 320 – Audit materiality" there is an inverse relationship between audit materiality and audit risk i.e. the higher the materiality level, the lower the audit risk and vice verse e.g. the risk that a particular account balance or class of transactions

could be misstated by an extremely large amount might be very low, but the risk that it could misstated by an extremely small amount might be very high. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example if, after planning from specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either :

(a) Reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control; or

(b) Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Materiality should be considered by the auditor when :

(a) Determining the nature, timing and extent of audit procedures;

(b) Evaluating the effect of misstatements.

8. Representation by Management: SA 580, "Representations by Management", establishes standards on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations, and the action to be taken if management refuses to provide appropriate representations. As per SA 580, representation by management constitutes audit evidence furnished by management to auditor in respect of any transaction entered into by the entity. Representation by Management is of great use to the auditor when other sufficient appropriate audit evidence cannot reasonably be expected to exist. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example, intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.

9. Audit Through the Computer: The sophistication of computers have finally reached the point where auditors can no longer audit around the system. They are forced to treat the computers as the target of the audit and audit through it. Auditing through the computer requires that the auditor submits data to the computer for processing. The results are then analysed for the processing reliability and accuracy of the computer programme. Technical and other developments that necessitated this approach include the following:

(i) On-line data entry.

(ii) Elimination or reduction of print-outs.

(iii) Real time file up dating.

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:

(i) 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.

(ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer programme may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.

(iii) The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.

(iv) 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 generally high costs and the need for extensive technical expertise when systems are complex. However, these disadvantages are really not that important if auditing through the computer is the only viable method of carrying out the audit.

Auditing through computer may be conducted through test data, computer programme, etc.

10. (a) Goods Sent on Consignment

(i) Verify the accounts sales submitted by the consignee showing goods sold and stock of goods in hand.

(ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the proforma invoices and accounts sales received during the year. If any consignment stock was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the stock in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

(v) See that goods in hand with the consignee have been shown distinctly under stocks.

(b) Receipt of Capital Subsidy

(i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(iv) Check relevant entries for receipt of subsidy.

(v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(c) Provision for Income Tax

(i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.

(ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.

(iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.

(iv) Compute tax payable as per the latest applicable rates in the Finance Act.

(v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc

11. Contingent Liability: A contingent liability will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events. The uncertainty as to whether there will be any legal obligation distinguishes a contingent liability from an actual liability. An obligation may be a contingent liability when the very basis of the obligation is contested. For example, when a claim is made against

a company in respect of infringement of a patent and the suing company does not possess a legitimate title. Schedule VI to the Companies Act, 1956 requires that contingent liabilities to be disclosed as a foot note to the balance sheet. Some examples of contingent liabilities include claims against the company not acknowledged as debts, arrears of fixed cumulative dividends, etc. AS 4 requires that in case there is a probability that a loss may be incurred and a reasonable estimate of the amount can be made, then such contingent liability must be adjusted in the financial statements. Otherwise, disclosure will have to be made describing nature of the event, uncertainties affecting the event and estimate of the financial effect or a statement that such an estimate cannot be made.

12. (a) Board's Powers to Appoint an Auditor: The appointment of an auditor is complete only on the acceptance of the offer by the auditor. The non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one, the matter would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. The casual vacancy is said to arise only in case of death, resignation, etc. Therefore, the Board is empowered to fill such a vacancy. Section 224(3) of the Companies Act, 1956, empowers the Central Government to fill up a vacancy in case no auditors are appointed or re-appointed at an annual general meeting (AGM). (It is also opined that the appointment of an auditor having been made by shareholders, sub-section (3) cannot be invoked. Thus the auditor could only be appointed by shareholders at general meeting). Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditor (s) appointed at the Annual General Meeting refuse to accept the appointment.

(b) Removal of First Auditors: With a view to safeguarding the auditor's independence, the law provides very stringent provisions so far as removal of an auditor before the expiry of the term is concerned. Section 224(7) of the Companies Act, 1956 provides that an auditor may be removed before the expiry of his term by the company in a general meeting only after obtaining the prior approval of the Central Government. An exception to this rule is that no such approval is required for the removal of the first auditor appointed by the Board of Directors under Section 224(5) of the Companies Act, 1956. Accordingly, A & Co., Chartered Accountants, being the first auditor of the company can be removed without the approval of the Central Government by the company by passing a ordinary resolution to that effect in the extra-ordinary general meeting called for the purpose.

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

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

13. (a) Provisions, Contingent Liabilities and Contingent Assets (AS 29): As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. A provision is a liability which can be measured only by using a substantial degree of estimation. In the instant case, the engineering firm, during the financial year 2007-08, did not carry out the repair work and hence no liability has arisen as at 31-03-08 as there was no obligation. Thus, the provision made by S Ltd. for repair work as on 31-03-08 is not correct as there was no obligation.

(b) Valuation of Inventories (AS 2): AS 2 deals with the principles and methods for determining the value at which inventories should be carried in the financial statements. Thus, items hold in the process of production is included in the definition of inventory.

In the given case, the management should have determined the stage of completion of the production and valued the work in process accordingly.

Work in Process (WIP) is normally, valued by taking the basic cost of materials, labour and proportionate factory overhead incurred upto the stage of completion. In view of the above, the argument that the value of opening and closing WIP is more or less same is not tenable as the cost of material, labour and overhead might be different and accordingly, arriving at the different valuation of opening and closing WIP is possible.

Moreover, WIP being a part of opening and closing stock, it needs to be shown in Profit and Loss A/c and carried as current assets in the balance sheet as per valuation.

Thus, if WIP is not valued, the auditor should qualify the report.

14. (a) Reliability of Audit Evidence: The degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be considerably increased if the xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly.

Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

(b) Responsibilities of Joint Auditors: In conducting a joint audit, the auditor(s) should bear in mind the possibility of existence of any fraud or error or any other irregularities in the accounts under audit. The principles laid down in SA 200A, SA 240 and SA 299 need to be read together for arriving at any conclusion. The principle of joint audit involves that each auditor is entitled to assume that other joint auditor has carried out his part of work properly. However, in this case, if it can be assumed that the joint auditors A and B have exercised reasonable care and skill in auditing the accounts of Ram & Som Ltd. and yet the concealment of transaction has taken place, both joint auditors cannot be held responsible for professional negligence. However, if such concealment could have been discovered by the exercise of reasonable care and skill, the auditors would be responsible for professional negligence. Therefore, it has to be seen that while dividing the work, the joint auditors have not left any area unattended and exercised reasonable care and skill while doing their work.

(c) Qualifications of an Auditor: A person shall be qualified for appointment as an auditor of a company, only if one is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Under the Chartered Accountants Act, 1949, only a chartered accountant holding the certificate of practice can engage in public practice. Abhishek does not hold a certificate of practice and hence cannot be appointed as an auditor of a company.

(d) Indebtedness to the Company: As per Section 226(3)(d) of the Companies Act, 1956, a person who is indebted to the company for an amount exceeding Rs.1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs.1000/- then he is not qualified for appointment as an auditor of a company. Accordingly, M's appointment is not valid and he is disqualified as the amount of debt exceeds Rs.1000. Even if the advance was taken for meeting out travelling expenses particularly before commencement of audit work, his appointment is not valid because in such a case also the auditor shall be indebted to the company. The auditor is entitled to recover fees on a progressive basis only.

15. (a) The guidance note on treatment of reserve created on revaluation of 'Fixed Assets' (16) advises that the accumulated losses must not be adjusted against revaluation reserve as it would amount to setting off actual losses against unrealised gains.

In the given problem Rs.1,50,000 transferred to revaluation reserve is unrealized gain whereas Rs.80,000 being debit balance in Profit and Loss Account is actual accumulated loss. This loss cannot be adjusted from unrealised gain raised as revaluation reserve.

(b) As per AS 12, government grant received for specific asset should be treated in either of the following way:

(1) Grant related to depreciable asset is treated as deferred income, which is recognized as revenue in P&L account on a systematic and rational basis over the useful life of the asset.

OR

(2) Grant to be shown as a deduction from gross value of the asset concerned in arriving at its book value and depreciation is charged on reduced value of fixed asset.

Interview of the above, the accounting treatment done by the hospital is not justified. The hospital has treated the grant as revenue item by taking it to the P&L account and has distorted the P&L account by treating the capital item as revenue. The audit should accordingly qualify the report.

16. (a) Disclaimer of Opinion: As per SA 500, the auditor must collect sufficient and appropriate audit evidence, on the basis of which he draws his conclusion to form an opinion, on the financial statements. But, if the auditor fails to obtain sufficient information to form an overall opinion on the matter contained in the financial statements, he issues a disclaimer of opinion.

The reasons due to which the auditor is not able to collect the audit evidence are:

(i) Scope of audit is restricted;

(ii) The auditor may not have access to the books of accounts, e.g.:

(a) Books of A/c's of the company seized by IT authorities.

(b) Sometimes, inventory verifications at locations outside the city bound the scope of duties of the auditor.

In such a case, the auditor must state in his audit report that –

"He is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion."

(b) Process of Judgment formation by auditor: After the audit, the opinion that the auditor expresses is the result of exercise of judgment on facts, evidence and circumstances which he comes across in the course of audit. The judgment is formed on the following basis:

(i) Identification of the assertions to be examined.

(ii) Evaluation of the assertion as to relative importance.

(iii) Collection of the information or evidence about the assertions to enable him to give an informed opinion.

(iv) Evaluation of evidence as valid or invalid, pertinent or not pertinent, sufficient or insufficient.

(v) Formulation of judgment as to the fairness of the assertions under consideration.

17. As per AS 6 on Depreciation Accounting, assessment of depreciation and the amount to be charged in respect thereof in an accounting year/period are usually based on the following three factors:

(i) Historical Cost.

(ii) Expected useful life of the asset.

(iii) Estimated residual value of the asset.

If the management's estimate of the useful life of an asset in shorter than that envisaged under the relevant statute (Companies Act) the depreciation is appropriately computed by applying a higher rate. The depreciation rate provided in Schedule XIV is the minimum rate and a company can charge higher than those prescribed.

Hence, in the instant case decision of Jagan Ltd., to write off the cost of water treatment plant over four years is absolutely correct and as per AS 6.

However, the company has wrongly charged full year's depreciation during 2007-08 instead of half year's depreciation as per requirement of Schedule XIV. The auditor should highlight this to the company and ask to rectify the same.

18. Under Section 227(3) of the Companies Act, 1956 the report of the auditor shall state the following matters:

(i) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for his audit.

(ii) Whether in his opinion, proper book of accounts as required by a low have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purpose of his audit have been received from the branches not visited by him.

(iii) Whether the report on the accounts of any branch office audited under Section 228 by a person other than the company's auditor has been forwarded to him as required to Section 228(3)(c) and how he has dealt with the same in preparing the auditor's report.

(iv) Whether the company's Balance sheet and Profit and Loss account dealt with by the report are in agreement with the books of accounts and returns.

(v) Whether in his opinion, the Balance sheet and the Profit and Loss account comply with the accounting standards referred to in sub-section (3c) of the Section 211 of the Companies Act, 1956.

(vi) The observations or comments of the auditor which have any adverse effect on the functioning of the company should be in bold or italics.

(vii) Whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of Section 274.

(viii) Whether Cess payable under Section 441A has been paid and if not, the details of the amount not so paid.

19. (a) Cut-off arrangements: It refers to separating the transaction of one period from those in the next period so that the working results of each period can be correctly ascertained. The arrangement that is made for the purpose is technically known as cut-off arrangements. This is basically part of the internal check system.

This arrangement is generally applied to sales, purchase and stock which are usually affected by the continuity of the business. The auditor satisfies by examination and test check that the cut-off arrangement adequately ensure that:

(i) Goods purchased have in fact been included in the inventories and liability have been provided for credit purchases and

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

The auditor may examine a sample of documents involving the movement of stock in and out of the stores shortly before and after the cut off date and ensure that these are correctly accounted for.

(b) Surprise Checks: Surprise checks are a part of normal audit procedures. An element of surprise can significantly improve the audit effectiveness. Wherever practical, an element of surprise should be incorporated in the audit procedures.

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client's office for audit and selection of areas of audit.

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client's staff. It helps in determining whether errors or frauds exists and if they exist, brings the matter promptly to the management's attention so that corrective action can be taken at the earliest. Surprise checks are very effective in verification of cash and investments, test checking of stock verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

20. Following are the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at service bureau:

    (1) Clearly defined liaison between bureau and user. A senior member of the user's staff should be appointed as the liaison officer.

    (2) System testing involving all clerical procedures at the user company.

    (3) Adequate file conversion checking procedures by the user.

    (4) Carefully planned rejection procedures to ensure the prompt correction and re-submission of rejections to meet bureau's processing schedules.

    (5) Additional control over the physical movement of data, for this, a copy or microfilm of documents are sent to the service bureau.

    (6) Output distribution controls.

    (7) Additional clerical controls at the company to verify the accuracy of computer processing.

    (8) If there are significant program checks, a review of reports by the user to ensure the check is functioning regularly.

    (9) A high degree of control over the maintenance of data on master files. This is necessary because the user has no physical control over the files.

21. (a) Amount incurred for Repairing and Overhauling of the Machinery: The amount spent to repair and overhaul the machinery should be treated as revenue expenditure irrespective of the amount. In this case, neither the earning capacity of the machine is enhanced nor the production cost is reduced. Therefore, it should be treated as a revenue expenditure. If any revenue expenditure is treated as capital, it would effectively inflate the profit for the year and consequently, the auditor would require to qualify his report.

    (b) Interest on Loan Borrowed to Purchase a Machinery: AS 16 "Borrowing Costs" allows capitalisation of borrowing costs, in case certain terms and conditions are fulfilled, i.e. costs can directly be attributed to the acquisition, construction or production of qualifying asset. A qualifying asset essentially acquires a substantial period of time to get ready for its intended use or sale. As such, interest on loan borrowed for purchasing machinery which has been installed two year's back must not be debited to Machinery A/c because it may result in overstatement of machinery value and profit. The auditor is required to qualify his report and bring out the quantitative impact on the assets and profit.

(c) Expenditure made by a pharma company to the legal advisor: Expenses of Rs.5 lakhs made by a pharma company to the legal advisor are legal expenses. Such expenses are incurred for defending the patent of a product of the pharma company is a revenue expenditure relating to the asset because it neither enhance the capacity of the asset nor any endurable benefit is obtained in future in addition to what is available at present. The legal fees paid is normally an expenditure in the revenue nature irrespective of the amount unless it is incurred for bringing any new assets in existence. Therefore, it is not correct to treat the expenditure as capital expenditure. It would result in the overstatement of assets value and profit and calls for qualification in the audit.

22. (a) Disclosure of Surplus on Sale of Investments: AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changing in Accounting Policies" prescribes the classification and disclosure of items in the statement on profit and loss account. AS 5 requires separate disclosure of prior period item, extraordinary items, etc. distinctly so as to reflect the financial position of enterprise for better understanding of users of financial statements. In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Accordingly the auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.

(b) Maintenance of Statutory Register: Register of members is a statutory book, which should be maintained by every company. The auditor should ascertain whether the company updates the register and then examine whether it is in agreement with the amount of issued capital. Because in the audit of share capital, it constitutes one of the internal documentary evidence. The auditor may also consider applying alternative audit procedures because if the company fails to update the register and the auditor fails to obtain sufficient appropriate audit evidence, the auditor may qualify his report.

23. (a) Receipt of Donations

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

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

(3) Receipt of Cheques: Receipt Book should have carbon copy for duplicate

receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

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

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

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

Remittance of donations to different NGOs

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

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

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

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

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

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

(b) Audit of receipts from Entry Fees of an Amusement Park

(1) Evaluate the internal control system regarding entry and collection for entry tickets including rotation of staff.

(2) Ensure that tickets are pre numbered.

(3) Ensure that the deposit of cash collected into the bank account very same next day.

(4) Compute analytical ratios in respect of the receipts pattern i.e. on week ends, holidays, etc. and make comparisons to draw conclusions.