

## PAPER – 6: AUDITING AND ASSURANCE

### PART – I : ACADEMIC UPDATE

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

#### 1. Duty to report on Frauds

I. Reporting to the Central Government- As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- (a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
- (b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
- (d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

- (e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
- (f) the report shall be in the form of a statement as specified in Form ADT-4.

II. Reporting to the Audit Committee or Board - Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

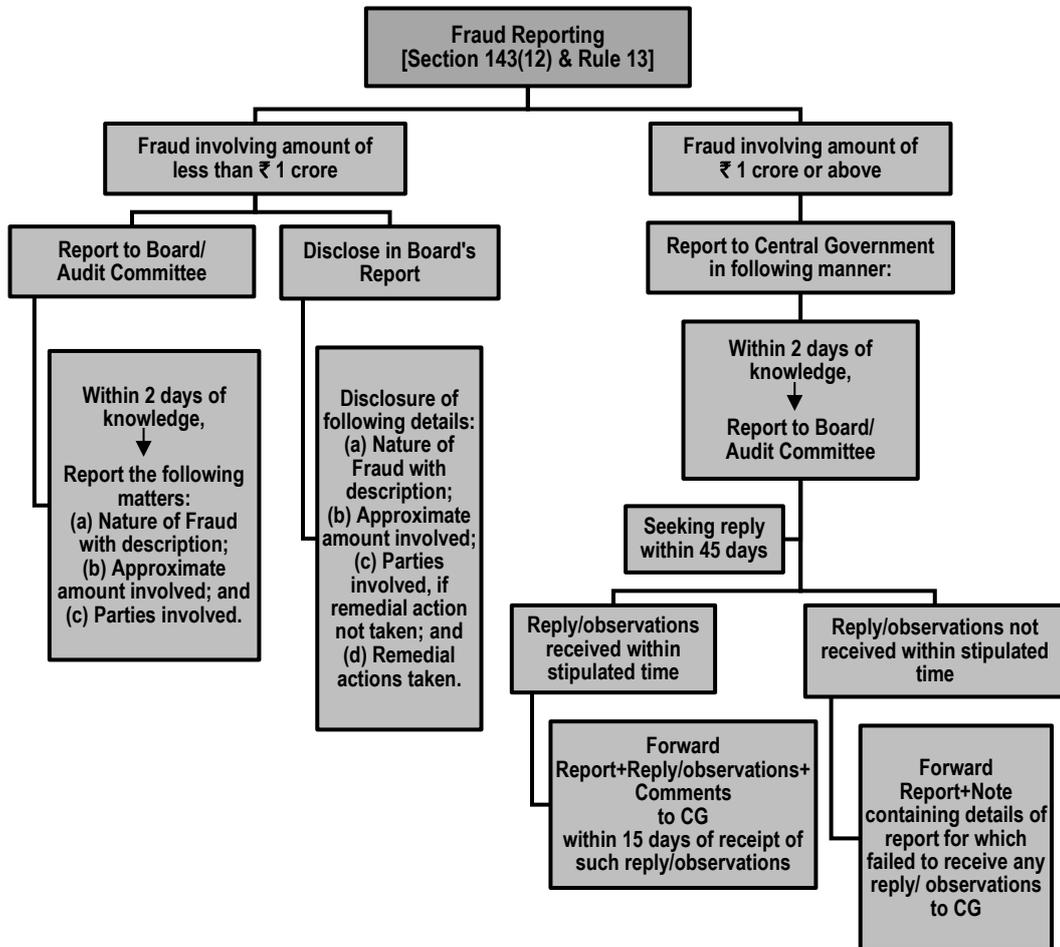
In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

- (a) Nature of Fraud with description;
- (b) Approximate amount involved; and
- (c) Parties involved.

III. Disclosure in the Board's Report - Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

- (a) Nature of Fraud with description;
- (b) Approximate Amount involved;
- (c) Parties involved, if remedial action not taken; and
- (d) Remedial actions taken.



**2. 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.

**3. Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]**

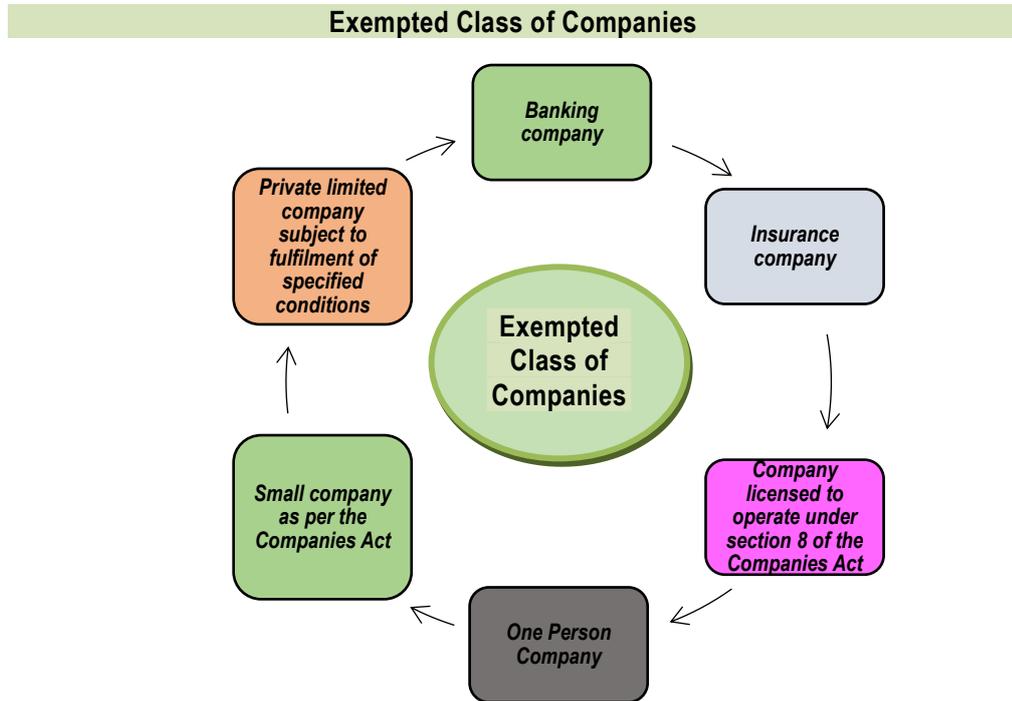
In exercise of the powers conferred by sub-section (11) of section 143 of the Companies Act, 2013 (18 of 2013 ) and in supersession of the Companies (Auditor's Report) Order, 2015 published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (ii), vide number S.O. 990 (E), dated the 10th April, 2015, except as respects things done or omitted to be done before such supersession, the Central Government, after consultation with the, committee constituted under proviso to sub-section (11) of section 143 of the Companies Act, 2013 hereby makes the following Order dated 29<sup>th</sup> March, 2016, namely:—

**I. Short title, application and commencement-**

- (1) This Order may be called the Companies (Auditor's Report) Order, 2016.
- (2) **Applicability of the Order:** The CARO, 2016 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 [hereinafter referred to as the Companies Act],

**However, the Order specifically exempts the following class of companies-**

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.



- II. **Auditor's report to contain matters specified in paragraphs 3 and 4** - Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after 1st April, 2015, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable:

It may be noted that the Order shall not apply to the auditor's report on consolidated financial statements.

- III. **Matters to be included in the auditor's report** - The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-
- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
  - (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

- (c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;
- (ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;
- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
  - (a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
  - (b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
  - (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.
- (v) in case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?
- (vi) whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.
- (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date

they became payable, shall be indicated;

- (b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).
- (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
- (ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- (x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;
- (xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;
- (xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;
- (xiv) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;

- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;
- (xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

**IV. Reasons to be stated for unfavourable or qualified answers -**

- (1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.
- (2) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

**4. Amendment in Companies (Cost Records and Audit) Rules, 2014**

- (I) Maintenance of Cost Records:** Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

The said rule has divided the list of companies into regulated sectors (Part A) and non-regulated sectors (Part B).

Additionally, as per clause (vi) to Paragraph 3 of the CARO, 2016, where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

- (II) Appointment of Cost Auditor:** Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an auditor within one hundred and eighty days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

- (a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;
- (b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;
- (c) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and
- (d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

**(III) Removal of Cost Auditor:** The cost auditor may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the cost auditor and recording the reasons for such removal in writing.

It may be noted that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect.

It may further be noted that the above provisions shall not prejudice the right of the cost auditor to resign from such office of the company.

**(IV) Submission of Cost Audit Report to the Central Government:** A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

**(V) Cost Audit Rules not to apply in certain cases:** The requirement for cost audit under these rules shall not be applicable to a company which is covered under rule 3, and,

- (i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or
- (ii) which is operating from a special economic zone.

- (iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

**5. Direction by Tribunal in case auditor acted in a fraudulent manner**

As per sub-section (5) of the section 140, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

**6. Curtailing right of the auditor regarding circulation of copy of representation in the case of appointment of Auditor other than retiring Auditor under section 140(4) of the Companies Act, 2013**

If the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by section 140(4) of the Companies Act, 2013 are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

**7. Re-opening of accounts on Court's or Tribunal's Orders**

Section 130 of the Companies Act, 2013 states that a company shall not re-open its books of account and not recast its financial statements, unless an application in this regard is made by the Central Government, the Income-tax authorities, the Securities and Exchange Board, any other statutory regulatory body or authority or any person concerned and an order is made by a court of competent jurisdiction or the Tribunal to the effect that—

- (i) the relevant earlier accounts were prepared in a fraudulent manner; or
- (ii) the affairs of the company were mismanaged during the relevant period, casting a doubt on the reliability of financial statements.

However, a notice shall be given by the Court or Tribunal in this regard and shall take into consideration the representations, if any.

**8. Voluntary revision of financial statements or Board's report**

Section 131 of the Companies Act, 2013 states that if it appears to the directors of a company that—

- (a) the financial statement of the company; or
- (b) the report of the Board,

do not comply with the provisions of section 129 (Financial statement) or section 134 (Financial statement, Board's report, etc.) they may prepare revised financial statement or a revised report in respect of any of the three preceding financial years after obtaining approval of the Tribunal on an application made by the company in such form and manner as may be prescribed and a copy of the order passed by the Tribunal shall be filed with the Registrar.

9. In exercise of powers conferred by section 143 read with sub-sections (1) and (2) of section 469 of the Companies Act, 2013 (18 of 2013), the Central Government hereby inserted the clause "(d) whether the company had provided requisite disclosures in its financial statements as to holdings as well as dealings in Specified Bank Notes during the period from 8th November, 2016 to 30th December, 2016 and if so, whether these are in accordance with the books of accounts maintained by the company.", after clause (c) in rule 11 of the Companies (Audit and Auditors) Rules, 2014.

10. In exercise of the powers conferred by section 139 read with sub-sections (1) and (2) of section 469 of the Companies Act, 2013 (18 of 2013), the Central Government hereby makes the following rules further to amend the Companies (Audit and Auditors) Rules, 2014, namely:—

"In the Companies (Audit and Auditors) Rules, 2014, in rule 5, in clause (b), for the word "twenty", the word "fifty" shall be substituted"

The impact of this amendment on the study material would be :

1. Point no. (II) - para 7.3.1 on page number 7.10 be read as -  
all private limited companies having paid up share capital of rupees fifty crores or more;
  2. In diagram appearing at page number 7.10, line in the middle box be read as -  
all private limited companies having paid up share capital  $\geq$  ₹ 50 crore
11. Additional requirement for claiming exemption under section 141(3)(g) for counting ceiling limit is available only if such company has not committed default in filing its financial statements under section 137 and annual returns under section 92 of the Act to the registrar as per notification dated 13 June 2017.

12. MCA vide Notification S.O. 2218(E) dated 13<sup>th</sup> July 2017 with respect to the Notification G.S.R. 583(E) Dated 13<sup>th</sup> June, 2017 (Corrigendum), stated that for the words "statement or" to read as "statement and" under section 143(3)(i).
13. Notification No. G.S.R. 583(E) stated that requirements of reporting under section 143(3)(i) read Rule 10 A of the Companies (Audit and Auditors) Rules, 2014 of the Companies Act 2013 shall not apply to certain private companies. Clarification regarding applicability of exemption given to certain private companies under section 143(3)(i) (vide circular no. 08/2017) clarified that the exemption shall be applicable for those audit reports in respect of financial statements pertaining to financial year, commencing on or after 1st April, 2016, which are made on or after the date of the said notification.
14. As per provisions of Section 143(3)(i) of companies Act, the Auditor Report shall state whether the Company has adequate internal financial controls system in place and the operating effectiveness of such controls. MCA vide its notification dated 13th June 2017 (G.S.R. 583(E)) amended the notification of the Government of India, In the ministry of corporate of affair, vide no G.S.R. 464(E) dated 05th June 2015 providing exemption from Internal Financial Controls to following private companies which is one person Company (OPC) or a Small Company; or Which has turnover less than ₹ 50 Crores as per latest audited financial statement or which has aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less then ₹ 25 Crore. The above exemption shall be applicable to a private company which has not committed a default in filing its financial statements under section 137 of the Companies Act 2013 or annual return under section 92 of Act with the Registrar. Further, in section 143 of the principal Act, (i) in sub-section (1), in the proviso, for the words "its subsidiaries", at both the places, the words "its subsidiaries and associate companies" shall be substituted; (ii) in sub-section (3), in clause (i), for the words "internal financial controls system", the words "internal financial controls with reference to financial statements" shall be substituted; (iii) in sub-section (14), in clause (a), for the words "cost accountant in practice", the words "cost accountant" shall be substituted.
15. **Amendment due to Companies (Amendment) Act 2017**
  - (i) By virtue of notification dated 21st March 2018, in exercise of the powers conferred by sub-section (3) of section 1 of the Companies Act, 2013 (18 of 2013), the Central Government hereby appoints the 21st March, 2018 as the date on which the provisions of subsections (3) and (11) of section 132 of the said Act shall come into force.
  - (ii) As per section 140(2), the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar, and in case of the companies referred to in section 139(5) i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his

resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees *or the remuneration of the auditor, whichever is less*, but which may extend to five lakh rupees as per section 140(3).

- (iii) Under sub-section (3) of section 141 along with Rule 10 of the Companies (Audit and Auditors) Rules, 2014 a person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company shall not be eligible for appointment as an auditor of a company
- (iv) By virtue of notification dated February 23, 2018, the Central Government has exempted the companies engaged in defence production to the extent of application of relevant Accounting Standard on segment reporting.
- (v) The Order for reopening of accounts not to be made beyond eight financial years immediately preceding the current financial year unless and until Government has, under Section 128(5) issued a direction for keeping books of account longer than 8 years, reopening of accounts can be made for such longer period.
- (vi) As per Section 143(3)(i) The auditors of all the companies shall report on the adequacy of internal financial control systems and its operating effectiveness. As per the recent amendment, the auditors are required to report on Internal Financial Control with reference to financial statements.
- (vii) Right of access by the auditor of a holding company to the accounts and records of the associate company, whose accounts are required to be consolidated. As per the recent amendment, this right has been extended to associates also.
- (viii) Enabling provisions for opportunity of being heard in Section 130 for auditor/ Chartered Accountant of the Company. As of now, there is no provision in the section for serving notice to the auditor/ chartered accountant in case of reopening of accounts. As per the recent amendment in the section has been brought enabling the Court/ Tribunal to give notice to any other party/ person concerned.
- (ix) Section 147 of the Companies Act, 2013 prescribes following punishments for contravention:
  - (1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.
  - (2) If an auditor of a company contravenes any of the provisions of section 139 section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend

to five lakh rupees **or four times the remuneration of the auditor, which ever is less.**

It may be noted that if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall **not be less than fifty thousand rupees** but which may extend to twenty-five lakh rupees **or eight times the remuneration of the auditor, which every is less**

- (3) Where an auditor has been convicted under sub-section (2), he shall be liable to:-
- (i) refund the remuneration received by him to the company;
  - (ii) and pay for damages to the company statutory bodies or authorities or to **members or the creditors of the Company** for loss arising out of incorrect or misleading statements of particulars made in his audit report.
- (4) The Central Government shall, by notification, specify any statutory body or authority of an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages the such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
- (5) Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in an fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil criminal as provided in this Act or in any other law for the time being in force, for such act shall be the partner or partners concerned of the audit firm and of the firm jointly and severally Provided that in case of criminal liability of an audit firm, in respect of liability other **than fine, the concerned partner or partners, who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable.**

**16. Quality Control and Engagement Standards:** The Council of the ICAI has inserted/ revised following Quality Control and Engagement Standards which are applicable for May 2018 and onward examination:

S. No.	No. of Standard	Title of the Standard
(1)	SA 260 (Revised)	Communication with Those Charged with Governance
(2)	SA 570 (Revised)	Going Concern

(3)	SA 610 (Revised)	Using the Work of Internal Auditors
(4)	SA 700 (Revised)	Forming an Opinion and Reporting on Financial Statements
(5)	SA701(New)	Communicating Key Audit Matters in the Independent Auditor's Report
(6)	SA 705 (Revised)	Modifications to the Opinion in the Independent Auditor's Report
(7)	SA 706 (Revised)	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

**Note-** Students are advised to refer Auditing Pronouncements for Intermediate Course – New Scheme.

**Note:** Students are also advised to refer RTP of Paper 1 Accounting and Paper 5 Advanced Accounting (for AS, Ind AS etc.) and Paper 2 Business Laws, Ethics and Communication (for academic updates relating to Company Law).

## PART – II: QUESTIONS AND ANSWERS

### QUESTIONS

1. State with reason (in short) whether the following statements are true or false:
  - (i) The preparation of financial statements does not involve judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity.
  - (ii) Audit procedures used to gather audit evidence may be effective for detecting an intentional misstatement.
  - (iii) An audit is an official investigation into alleged wrongdoing.
  - (iv) The matter of difficulty, time, or cost involved is in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.
  - (v) There is no relation between Audit Plans and knowledge of the client's business
  - (vi) Planning is not a discrete phase of an audit, but rather a continual and iterative process.
  - (vii) Audit documentation is a substitute for the entity's accounting records.
  - (viii) AB & Co. is an audit firm having partners Mr. A and Mr. B. Mr. C, the relative of Mr. B is holding securities having face value of ₹ 2,00,000 in XYZ Ltd. AB & Co. is qualified for being appointed as an auditor of XYZ Ltd.

- (ix) When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall not perform substantive procedures that are specifically responsive to that risk.
- (x) The SAs ordinarily refer to inherent risk and control risk separately.

**Nature of Auditing**

2.
  - (a) "Statements" and "Guidance Notes" of ICAI- whether mandatory or recommendatory?
  - (b) Inquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements.
  - (c) The discipline of behavioural science is closely linked with the subject of auditing. Discuss.
3. Discuss with reference to SAs:
  - (a) What do you mean by "Written Representations"? As an auditor, how you will deal if management does not provide requested written representations?
  - (b) "Operating Conditions" that may cast doubt about going concern assumption.
  - (c) The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement?
4.
  - (a) With reference of SA 250, give some examples or matters indicating to the auditor about non compliance of laws & regulations by management.
  - (b) The auditor may exercise his judgement to identify which risks are significant risks. Explain the above in context of SA-315.

**Basic Concepts in Auditing**

5.
  - (a) What is "Audit Evidence"?
  - (b) What are the various audit procedures to obtain audit evidence? Mention the same in brief.
  - (c) Discuss the principles, which are useful in assessing the reliability of audit evidence.
6. "Risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures need to be considered." Explain stating the different categories of assertions used by the auditor.
7.
  - (a) What do you mean by Analytical procedures? How such procedures are helpful in auditing?
  - (b) Explain concept of 'Materiality'.

**Preparation for an Audit**

8. (a) Mention any four areas where surprise checks can significantly improve the effectiveness of an audit.
- (b) In a system based audit, test checking approach provides a good base for the auditor to form his opinion on the financial statements. Give your comments.
- (c) "It is not mandatory to send a new engagement letter in recurring audit, but sometimes it becomes mandatory to send new letter". Explain those situations where new engagement letter is to be sent.
9. (a) How does an audit programme help to plan and perform the audit?
- (b) Draft an audit programme to audit the receipts of a cinema theatre owned by a partnership firm.

**Internal Control**

10. (a) In a medium size trading organisation the accountant was given additional responsibility of making recoveries from the trade receivables. On one occasion, when an insurance claim of ₹ 45,000 was received, he credited the same to the account of a trade receivable and misappropriated the cash which he had recovered from the said trade receivable. Pinpoint weaknesses in the internal control system which led to this situation. Comment.
- (b) What are the inherent limitations of Internal Control system?
11. (a) 'Doing an audit in a Computerised Information System (CIS) environment is simpler since the trial balance always tallies'. Analyse critically.
- (b) Why are Computer Aided Audit Techniques (CAATs) required in Computerised Information System (CIS) environment? What are the advantages of CAATs?

**Vouching & Verification of Assets and Liabilities**

12. (a) How will you vouch/verify Rental Receipts.
- (b) 'In vouching payments, the auditor does not merely check proof that money has been paid away.' Discuss.
13. How will you vouch and/or verify the following:
- (a) Purchase of quoted investment.
- (b) Discounted bill receivable dishonoured.
- (c) Retirement Gratuity to Employees.
- (d) Receipt of special backward area subsidy from Government.
14. (a) Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly

ascertained. Explain.

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

### **The Company Audit**

15. 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.
16. As an auditor comment on the following situations/statements:
- (a) The company due to liquidity crises sold and leased back the same vehicles from leasing companies. In the notes to accounts, the company stated 'Vehicles taken on lease repayable in 46 instalments of ₹ 36,650 each'.
  - (b) A portion of Share Premium utilised to declare 40% dividend.
17. (a) Why Central Government permission is required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term?
- (b) What are the special considerations in an audit of a Limited Company?
18. Strong Ltd. holding 60% of the equity shares in Weak Ltd. purchased goods worth ₹ 50 Lakhs from Weak Ltd. during the financial year 2016-17. The Managing Director of Strong Ltd. is of the opinion that it is normal business activity and there is no need to disclose the same in the final accounts of the Company. Comment.

### **Special Audits**

19. 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.
20. (a) Mention any eight special points which you as an auditor would look into while auditing the books of a partnership firm.
- (b) What special steps will you take into consideration in auditing the receipts from entry fees of an amusement part? Mention any four points specific to the issue.

## SUGGESTED ANSWERS / HINTS

1. (i) **Incorrect:** 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.
- (ii) **Incorrect:** Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- (iii) **Incorrect:** 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.
- (iv) **Incorrect:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.
- Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, 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.
- (v) **Incorrect:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business
- (vi) **Correct:** According to SA-300, "Planning an Audit of Financial Statements", planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.
- (vii) **Incorrect:** The auditor may include copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity's accounting records.
- (viii) **Incorrect:** As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if his relative is holding any security of or interest in the company of face value exceeding ₹ 1 lakh.
- Therefore, AB & Co. shall be disqualified for being appointed as an auditor of XYZ Ltd. as Mr. C, the relative of Mr. B who is a partner in AB & Co., is holding securities in XYZ Ltd. having face value of ₹ 2 lakh.

- (ix) **Incorrect:** When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.
- (x) **Incorrect:** The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

2. (a) **Statements and Guidance Notes of ICAI – whether Mandatory or Recommendatory:**

- (i) **Statements:** The ‘Statements’ have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. ‘Statements’ therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute to ensure that statements are followed and complied with.

- (ii) **Guidance Notes:** ‘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. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are, however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function.

- (b) **Inquiring from Management to Evaluate Subsequent Event:** As per SA 560 “Subsequent Events”, in inquiring of management and, where appropriate, those

charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters-

- (i) Whether new commitments, borrowings or guarantees have been entered into.
- (ii) Whether sales or acquisitions of assets have occurred or are planned.
- (iii) 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.
- (iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- (v) Whether there have been any developments regarding contingencies.
- (vi) Whether any unusual accounting adjustments have been made or are contemplated.
- (vii) 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.
- (viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- (ix) Whether any events have occurred that are relevant to the recoverability of assets.

- (c) **The Discipline of Behavioural Science is Closely Linked with the Subject of Auditing:** The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are

competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

3. (a) **Written Representations:** As per SA 580, "Written Representation" is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. These representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Requested Written Representations not provided by Management: If management does not provide one or more of the requested written representations, the auditor shall-

- (i) discuss the matter with management;
- (ii) re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- (iii) take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if management does not provide the written representations.

- (b) **Operating Conditions Casting Doubt About Going Concern Assumption:** The following are examples of operating events or conditions that, may cast significant doubt about the going concern assumption as per SA 570 "Going Concern"-

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

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

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

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Further, while obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Therefore, we do agree with the statement.

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) Identification of Significant Risks:** SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

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

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

- (i) Whether the risk is a risk of fraud;
- (ii) Whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment etc. and therefore requires specific attention;
- (iii) The complexity of transactions;
- (iv) Whether the risk involves significant transactions with related parties;
- (v) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

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

- (b) Audit Procedures to Obtain Audit Evidence:** According to SA 500 "Audit Evidence", the auditor may obtain evidence by one or more of the following audit procedures-

**Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal

records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

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

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

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

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

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

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

**Analytical Procedures:** Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified

fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

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

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

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

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

(c) **Reliability of Audit Evidence:** SA 500 on "Audit Evidence" provides that the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- (1) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- (2) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

- (3) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
  - (4) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
  - (5) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.
- 6. Risk of Material Misstatement at the Assertion Level:** According to SA 315 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment”, risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms -

**(I) Assertions about classes of transactions and events for the period under audit:**

- (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
- (ii) Completeness—all transactions and events that should have been recorded have been recorded.
- (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
- (iv) Cut-off—transactions and events have been recorded in the correct accounting period.
- (v) Classification—transactions and events have been recorded in the proper accounts.

**(II) Assertions about account balances at the period end:**

- (i) Existence—assets, liabilities, and equity interests exist.
- (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

- (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
- (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

**(III) Assertions about presentation and disclosure:**

- (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
- (ii) Completeness—all disclosures that should have been included in the financial statements have been included.
- (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
- (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

7. (a) **SA 520 ‘Analytical Procedures’:** As per SA 520, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor’s choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example: comparable information for prior periods; anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation; and similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example: among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages; and between financial information and relevant non-financial information, such as payroll costs to number of employees.

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Analytical procedures are used for the following purposes:

- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
  - (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.
- (b) **Concept of Materiality:** According to SA 320 "Materiality in Planning and Performing an Audit", financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
  - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the 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) **Areas where Surprise Checks can significantly improve the effectiveness of an Audit:** Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are-

- (i) Verification of cash and investments.
- (ii) Inventory.
- (iii) Internal control and internal checks.
- (iv) Books of prime entries and statutory registers.

(b) **Test Checking in System Based Audit:** System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control to provide assurance that-

- (i) All the transactions and information have been recorded,
- (ii) Fraud and errors, if any, in preparing the accounts will be identified,
- (iii) All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,
- (iv) There is compliance with statutory regulations.

After the auditor has ascertained the client's accounting system, he should assess it to satisfy the above-mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he resorts to actual testing of the system in operation. This he does on a selective basis, i.e., he adopts test checking technique. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and/or by auditing in depth. This approach is adopted in system based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability. By this, the auditor first establishes how reliable the system is and then decides how much

detailed checking of the transactions and verification of assets and liabilities he must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

- (c) **Issue of Audit Engagement Letter in Recurring Audits:** As per SA 210, "Agreeing the Terms of Audit Engagements", on recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

It is not necessary to issue audit engagement letter each year for repetitive audit. It is enough if the same had been issued at the time of taking initial engagement. However, in the following situations it is appropriate to revise the terms of the audit engagement or to remind the entity of existing terms-

- (i) Any indication that the entity misunderstands the objective and scope of the audit.
- (ii) Any revised or special terms of the audit engagement.
- (iii) A recent change in senior management or board of directors.
- (iv) A significant change in ownership.
- (v) A significant change in nature or size of the entity's business.
- (vi) A change in legal or regulatory requirements.
- (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
- (viii) A change in other reporting requirements.

9. (a) **The Role of Audit Programme in Audit Plan and Performance:** The audit programme is helpful both in planning and performance stages of audit-
- (i) The audit programme lists down areas of audit before commencement.
  - (ii) The audit timing is built therein; thereby it becomes a schedule of audit plan.
  - (iii) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.
  - (iv) It specifies the procedures to be checked during the audit.
  - (v) As the audit work is split into various elements of procedures to be performed, the audit programme acts as a guiding chart or check list during the performance of audit.
  - (vi) Since the staff in charge of each work is specified and they sign the programme,

it extracts the responsibility from the audit assistants.

- (vii) The working papers of the audit staff can be reviewed against the audit programme which helps a base of reference for evaluation of the performance before reporting on the financial statements.
- (viii) It also helps in preparing a diary of the performance and plan and also base for billing the clients for the time and manpower involved in the audit.

**(b) Audit Programme for Receipts of Cinema Theatre of a Firm:** Audit programme for checking the receipts of a cinema theatre of a partnership firm-

- (i) The partnership deed should be first scrutinized.
- (ii) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.
- (iii) The internal control for collections from sale of tickets should be checked.
- (iv) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.
- (v) Check the rough cash book and reconcile from the inventory of ticket books issued, the cash to be collected each day.
- (vi) Check that the cash balance and ticket sales from inventory is daily checked by the manager.
- (vii) Check that the collections are banked daily, the very next day.
- (viii) See rates for each class and the ticket rates are as per current prices.
- (ix) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.
- (x) Check the relation between the amounts of tax collected and sales.
- (xi) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.
- (xii) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.
- (xiii) The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.
- (xiv) Do surprise checking of cash balances.
- (xv) See that cash collections are insured and the policy is in force.

**10. (a) Weaknesses in the Internal Control System:** Following two essential features of internal control are relevant here-

- (i) Breaking the chain of the work in a manner so that no single person can handle

a transaction from the beginning to the end, and

- (ii) Segregation of accounting and custodial functions.

**Weakness in internal control system in the instant case-**

- (a) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.
- (b) It also appears that system for issuing receipts for amount received - whether cash or cheque is also lacking.
- (c) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system.

- (b) **Inherent Limitations of Internal Control System:** Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as-

- (i) Management's consideration that cost of an internal control does not exceeds the expected benefits.
- (ii) Most controls do not tend to be directed at unusual transactions.
- (iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.
- (iv) The possibility that control may be circumvented through collusion with employees or outsiders.
- (v) The possibility that a person responsible for exercising control may abuse that authority.
- (vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.
- (vii) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.
- (viii) Inherent limitations of Audit.

- 11. (a) **Audit in a Computerised Information System (CIS) Environment:** Though it is true that in CIS environment the trial balance always tallies, the same cannot imply that the job of an auditor becomes simpler. There can still be some accounting errors like omission of certain entries, compensating errors, duplication of entries, errors of commission in the form of wrong account head is posted. Possibility of "Window Dressing" and/or "Creation of Secret Reserves" where the trial balance tallied. At

present, due to complex business environment the importance of trial balance cannot be judged only upto the arithmetical accuracy but the nature of transactions recorded in the books and appear in the trial balance should be focused.

The emergence of new forms of financial instruments like options and futures, derivatives, off balance sheet financing etc have given rise to further complexities in recording and disclosure of transactions. In an audit, besides the tallying of a trial balance, there are also other issue like estimation of provision for depreciation, valuation of inventories, obtaining audit evidence, ensuring compliance procedure and carrying out substantive procedure, verification of assets & liabilities their valuation etc. which still requires judgement to be exercised by the auditor.

Responsibility of expressing an audit opinion and objectives of an audit are not changed in the audit in CIS environment. Therefore, it can be said that simply because of CIS environment and the trial balance has tallied it does not mean that the audit would become simpler.

- (b) **Computer Aided Audit Techniques (CAATs):** The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. CAATs are such techniques applied through the computer which are used in the verifying the data being processed by it.

System characteristics resulting from the nature of Computerised Information System (CIS) environment that demand the use of Computer Aided Audit Techniques (CAAT) are:

- (i) **Absence of input documents:** Data may be entered directly into the computer systems without supporting documents. In on-line transaction systems, written evidence of individual data entry authorization, e.g., credit limit approval may not be available.
- (ii) **Lack of visible transaction trail:** Certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In CIS environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.
- (iii) **Lack of visible output:** In a manual system, it is normally possible to examine visually the results of processing. In CIS environment, the results of processing may not be printed or only a summary data may be printed. Thus, the lack of visible output may result in the need to access data retained on machine readable files.
- (iv) **Ease of Access to data and computer programmes:** Data and computer programmes may be altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and

allocation of, data and programmes by persons inside or outside the entity.

#### **Advantages of CAAT**

- (i) **Audit effectiveness:** The effectiveness and efficiency of auditing procedures will be improved through the use of CAAT in obtaining and evaluating audit evidence, for example –
  - (a) Some transactions may be tested more effectively for a similar level of cost by using the computer.
  - (b) In applying analytical review procedures, transactions or balance details of unusual items may be reviewed and reports got printed more efficiently by using the computer.
- (ii) **Savings in time:** The auditor can save time by reviewing the CIS controls using CAAT than through other audit procedures.
- (iii) **Effective test checking and examination in depth:** CAAT permits effective examination in depth of selected transactions since the auditor constructs the lost audit trail.

#### **12. (a) Rental Receipts:**

- (i) Check copies of bills or rent receipt issued to the tenant with reference to tenancy agreement and bills of charges paid by the landlord on behalf of tenants.
  - (ii) The entries in the rental register in respect of rent accrued should be traced with reference to copies of rental bills.
  - (iii) Scrutinize the account of collecting agent when the rent is collected by such agent.
  - (iv) Vouch the entries for rent received in advance and ensure proper adjustment is made.
  - (v) Investigate into abnormal rent outstanding.
  - (vi) Reconcile the outstanding rent and see that proper provision is made if unrecoverable.
  - (vii) If rent is received net of TDS, see that rent income is shown at gross and TDS is shown in Balance Sheet as advance Tax.
- (b) **Vouching- Backbone of Auditing:** Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching is not merely to ascertain that money has been paid away; but the auditor aims to obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account that –

- (i) a transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period;
- (ii) a transaction pertains to entity and took place during the relevant period;
- (iii) all transactions which have actually occurred have been recorded;
- (iv) all transactions were properly authorised; and
- (v) transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transaction in the context of the client's business, nature of the organisation and organisational rules.

Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy but also to see its substantial accuracy and then to make a report thereon.

This substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records.

**13 (a) Purchase of Quoted Investment:**

- (i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., error cum-dividend/interest/right/bonus.
- (ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.
- (iii) Verify the amount paid towards purchase of investments.
- (iv) Trace the amount in the cheque book counterfoils and bank statements.
- (v) Obtain a schedule of investment from Management for physical verification at the year end.
- (vi) Verify the investment certificate to confirm title.

- (vii) Confirm compliance with statutory provisions such as 143(1) of the Companies Act, 2013.
- (viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

**(b) Discounted Bill Receivable Dishonoured:**

- (i) Obtain the schedule of discounted bills receivable dishonoured.
- (ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.
- (iii) Verify the bills receivable returned by the bank along with bank's advice.
- (iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the trade receivable is also debited.
- (v) Check that bank commission, if any, charged by the bank has been recovered from the party.

**(c) Retirement Gratuity to Employees:**

- (i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.
- (ii) Verify computation of liability of gratuity on the aggregate basis.
- (iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.
- (iv) See that the annual premium has been charged to the Statement of Profit and Loss.
- (v) Ensure that the accounting treatment is in accordance with AS 15 "Employee Benefits".

**(d) Receipt of Special Backward Area Subsidy from Government:**

- (i) The claim for backward area subsidy submitted to the authorities should be studied.
- (ii) It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature is to fact.
- (iii) The accounting of grant should be in accordance with AS 12 "Accounting for Government Grants". The revenue grant can be taken to income statement, with appropriate disclosure.

- (iv) The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to Statement of Profit and Loss each year in proportion to depreciation of that asset charged in Statement of Profit and Loss.
- (v) The receipt of the grant should be checked with bank statement, remittance challan etc.
- (vi) The conditions attached to grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

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

- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
- (ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of inventory into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking for perfect and correct presentation in the financial statements.

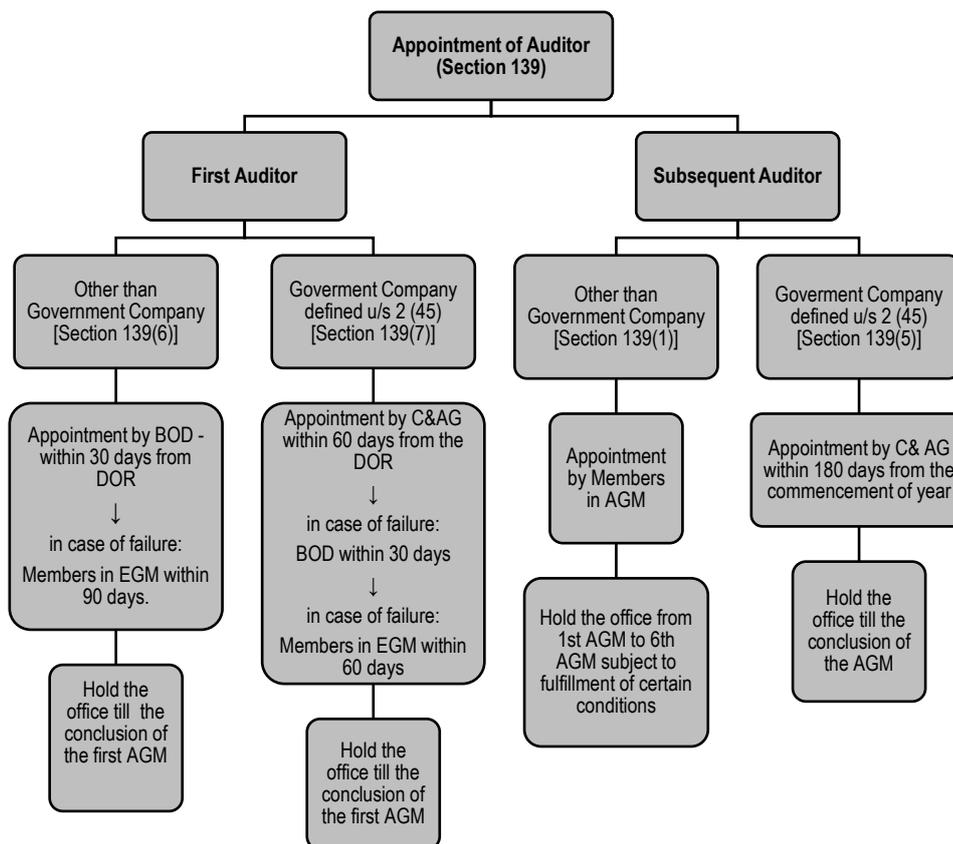
(b) **Decrease in Rate of Gross Profit on Sales:** When rate of Gross Profit on Sales of a manufacturing company has sharply decreased in comparison to the previous year, the auditor should satisfy the reasons for the same. Following factors should be considered which might cause decrease in the Gross Profit of the manufacturing company-

- (i) Undervaluation of closing inventory or overvaluation of opening inventory either due to wrong valuation of inventory or mistake in inventory taking.
- (ii) Change in the basis of inventory valuation. For example, opening inventory was valued at market price above cost when closing inventory valued at cost which is below the market price.

- (iii) Inclusion in the current year, the amount of goods purchased in the previous year, that were received and taken in the same year.
- (iv) Reversal of fictitious sale entries recorded in the previous year to boost up profit.
- (v) Sales return entry passed two times or entry for purchase return has not been passed whenever goods are returned to suppliers.
- (vi) Excess provision for wages or direct expenses have been made.
- (vii) Goods sent out for sale on approval or on a consignment basis not included in closing inventory.
- (viii) Value of unusual inventory of consumable stores (fuel and packing materials) are not shown as inventory or not adjusted from corresponding expenses.
- (ix) Expenses which should be charged in the Profit and Loss Account but wrongly charged to the Trading Account.
- (x) Insurance claim received in respect of goods lost in transit or destroyed by fire, not credited in Trading Account.
- (xi) Goods sold or given as samples or destroyed, not accounted for.

**15. 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.
16. (a) **Sale and Leaseback of Vehicles:** Under a lease agreement, the lessee acquires the right to use an asset for an agreed period of time in consideration for payment of rent to the lessor. The legal ownership of the asset remains with the lessor.

In the instant case, the company had sold vehicles to two leasing companies to meet its liquidity crises and took them back on lease. In the notes to the accounts it had disclosed about instalments payable to different leasing companies, but without disclosing the true nature of the transaction as covered by AS 19, "Leases".

The transaction entered into by the company is a classic case of sale and leaseback transaction. In case of such transactions, the sale price of assets and lease rentals normally do not represent fair value since the same are negotiated as a package. In case such a transaction is an operating lease and it is clear that the rentals and the sale price are established at fair value, then in effect it is a normal sale transaction and any profit or loss is normally recognised immediately.

If the sale price is below fair value, any profit or loss is recognised immediately, except that, if the loss is compensated by future rentals at below market price, it is deferred and amortized in proportion to the rental payments over the useful life of the asset.

If the sale price is above fair value, the excess over fair value is deferred and amortized over the useful life or the asset.

Therefore, it would be important for the auditor to determine whether the amount of instalments payable is fair having regard to sale price of assets. In case the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income.

Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

Further, disclosure shall have to be made separately of such transaction in terms of AS 5.

The auditor should, therefore, suitably qualify his report since proper disclosures have not been made as per the requirement of accounting standards.

**(b) Utilisation of Share Premium:** Section 52 of the Companies Act, 2013 deals with application of premium received on issues of shares. Section 52(1) requires creation of Securities Premium Account and states that the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the premium account were paid-up share capital of the company. Section 52(2) lays down that the securities premium account may be applied by the company-

- (a) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;
- (b) in writing off the preliminary expenses of the company;
- (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- (e) for the purchase of its own shares or other securities under Section 68.

Thus, it is clear from the above that share premium can be utilised only for specific purposes. Further, section 123 of the Companies Act, 2013 also specifies the sources from which dividends can be paid and requires the same to be only paid out of past profits, general reserve or any other free reserve. Hence, declaration of dividends out of share premium is not proper and, consequently, the auditor shall have to qualify the audit report.

**17. (a) Permission of Central Government for Removal of Auditor Under Section 140(1) of the Companies Act, 2013:** Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence.

Further, in case of conflict of interest the shareholders may remove the auditors in their own interest.

Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand if auditor has completed his term i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

**(b) Special Consideration in an Audit of a Limited Company:**

- (i) Initial Verification
  - (a) Examine basic documents, viz., Memorandum of Association and Articles of Association of the company, prospectus issued, etc.
  - (b) Check the certificate of incorporation and certificate of commencement of business.
  - (c) Examine transactions entered into by the company with reference to the date of these certificates.
  - (d) Verify the contracts entered into with vendors or other persons for purchase of property, payment of commission, etc.
- (ii) Board's Duties
  - (a) Ensure that Board of Directors act well within their powers and no *ultra vires* act is ratified.
  - (b) Also check that the Board has not exercised the powers that are to be exercised by the members in their General Meeting.
  - (c) Verify that only acts that can be delegated are in fact delegated to others and that the Board takes decisions only by resolutions at properly constituted meetings.
  - (d) Inspect minutes of meetings of Board of Directors.
  - (e) Verify whether the Board has obtained sanction of the Central Government, wherever applicable, e.g., increase in remuneration to Directors in excess of specified amounts.
- (iii) Compliance with relevant provisions of the Companies Act, 2013 relating to share capital; provision relating to Board provisions relating to accounts and audit, etc.

- (iv) Compliance with provisions relating to Sections 139 to 146 of the Companies Act, 2013.

**18. Disclosure of Related Party Transaction:** As per definition given in the AS 18 "Related Party Disclosure" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged. Strong Ltd. is the holding company of Weak Ltd. as it holds more than 50% of the voting power of Weak Ltd. and thus should be treated as related parties as per AS-18.

According to AS-18, in the case of related party transactions, following facts should be disclosed:

- (i) Related party relationship, name and nature of relationship.
- (ii) If there is transaction between the related parties then descriptions of the nature of transaction, volume of the transaction outstanding at the Balance Sheet date etc.

Further, as per Section 188 of the Companies Act, 2013 also prescribes to take the permission of the Board of Directors by resolution at board meeting for such related party transactions.

In the instant case since there is related party transaction the contention of Managing Director of Strong Ltd. is not correct. The auditor is required to verify the compliance of section 188 of the Companies Act and insist to make proper disclosure as required by AS-18 and if the management refuses, the auditor as per SA 550 "Related Parties", should express a qualified opinion. The auditor is also required to report under Clause (xiii) of Para 3 of CARO, 2016.

**19. Receipt of Donations:**

- (i) **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.
- (ii) **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.
- (iii) **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.
- (iv) **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.

- (v) **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.
- (vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

**Remittance of Donations to Different NGOs:**

- (i) **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.
  - (ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
  - (iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
  - (iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
  - (v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
  - (vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.
20. (a) **Special Points in Audit of a Partnership Firm:** Matters which should be specially considered in the audit of accounts of a partnership firm are as under -
- (i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
  - (ii) Examine the partnership deed signed by all partners and its registration with the registrar of firms. Also ascertain from the partnership deed about capital contribution, profit sharing ratios, interest on capital contribution, powers and responsibilities of the partners, etc.
  - (iii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans, purchase of assets, extraordinary contracts entered into and other such matters which are not of a routine nature.
  - (iv) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

- (v) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
  - (vi) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreement.
  - (vii) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners. Also see various requirements of legislations applicable to the partnership firm like Section 44(AB) of the Income-tax Act, 1961 have been complied with.
  - (viii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.
- (b) Audit of receipts from Entry Fees of an Amusement Park:**
- (i) Evaluate the internal control system regarding entry and collection for entry tickets including rotation of staff.
  - (ii) Ensure that tickets are pre numbered.
  - (iii) Ensure that the deposit of cash collected into the bank account very same next day.
  - (iv) Compute analytical ratios in respect of the receipts pattern i.e. on weekends, holidays, etc. and make comparisons to draw conclusions.