Auditing – Paper II

(As per the Revised Syllabus and Question Paper Pattern of Courses of B.Com. (Accounting and Finance) Programme at Semester III with Effect from the Academic Year 2014-2015)

[Winner of "*Best Commerce Author 2013-14*" by Maharashtra Commerce Association]

Dr. Nisikant Jha

Ph.D., ICWA, PGDBM (MBA), M.Com.,
International Executive MBA UBI, Brussels, Belgium; BEC Cambridge University,
Assistant Professor in Accounts & Coordinator
for
BAF, Thakur College of Science and Commerce,
UGC Recognised, University of Mumbai.
Visiting Faculty for: MBA in United Business Institutes, Brussels, Belgium, Europe,
CFA & CFP Professional Courses of USA, CIMA Professional Courses of London,
CA & CS Professional Courses of India, M.Com. & M.Phil., Hinduja College,
Ph.D. Guide [Research Supervisor] & Professor for Research Methodology.

CA. Swati Gupta

A.C.A, M. Com, D.F.M, UGC Net.
Asst Prof Accounts of Thakur College of Science & Commerence.

Ca. Baijul Mehta

ACA, M.Com, MBA
Asst Prof in Accounts at Thakur College of Science & commerence

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Nagpur : Kundanlal Chandak Industrial Estate, Ghat Road, Nagpur - 440 018. Phone: 0712-2738731, 3296733; Telefax: 0712-2721216

Bengaluru : No. 16/1 (Old 12/1), 1st Floor, Next to Hotel Highlands, Madhava Nagar, Race Course Road, Bengaluru - 560 001. Phone: 080-22286611, 22385461, 4113 8821, 22281541

Hyderabad : No. 3-4-184, Lingampally, Besides Raghavendra Swamy Matham, Kachiguda, Hyderabad - 500 027. Phone: 040-27560041, 27550139

Chennai : 8/2 Madley 2nd street, T. Nagar, Chennai - 600 017. Mobile: 09320490962

Pune : First Floor, "Laksha" Apartment, No. 527, Mehunpura, Shaniwarpeth (Near Prabhat Theatre), Pune - 411 030. Phone: 020-24496323/24496333; Mobile: 09370579333

Lucknow : House No 731, Shekhupura Colony, Near B.D. Convent School, Aliganj, Lucknow - 226 022. Phone: 0522-4012353; Mobile: 09307501549

Ahmedabad : 114, "SHAIL", 1st Floor, Opp. Madhu Sudan House, C.G. Road, Navrang Pura, Ahmedabad - 380 009. Phone: 079-26560126; Mobile: 09377088847

Ernakulam : 39/176 (New No: 60/251) 1st Floor, Karikkamuri Road, Ernakulam, Kochi – 682011. Phone: 0484-2378012, 2378016; Mobile: 09387122121

Bhubaneswar : 5 Station Square, Bhubaneswar - 751 001 (Odisha). Phone: 0674-2532129, Mobile: 09338746007

Indore : Kesardeep Avenue Extension, 73, Narayan Bagh, Flat No. 302, IIIrd Floor, Near Humpty Dumpty School, Indore - 452 007 (M.P.). Mobile: 09303399304

Kolkata : 108/4, Beliaghata Main Road, Near ID Hospital, Opp. SBI Bank, Kolkata - 700 010, Phone: 033-32449649, Mobile: 7439040301

Guwahati : House No. 15, Behind Pragjyotish College, Near Sharma Printing Press, P.O. Bharalumukh, Guwahati - 781009, (Assam). Mobile: 09883055590, 08486355289, 7439040301

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Preface

"It is an exciting time to be an accountant." This is the way we've started our auditing lectures since the last five years. With all of the changes that have occurred in the audit environment, it is an exciting time to study accounting and to be an auditing teacher.

This book recognizes the changes that have occurred in the profession in the past 10 years: new regulatory boards, ever-changing auditing and accounting standards, and a move in the profession to merge US Standards with International Standards. All of these changes make this an exciting time to work as an auditor.

Why a new auditing textbook? — This textbook was written to combine the teaching of theory and practice. Accounting students usually do not like theory; they are happier solving problems and focusing on "practical" issues. Contemporary texts weigh in heavily on theory, many of them devoting most of the first half of the text to theory and waiting until the second half to address the issues and the problem solving of auditing. In my teaching experience, we have found that students often thought the theory sections to be boring, causing them to become discouraged and stifling their interest in the business process rules that came later in the course. Obviously, students need a theoretical basis so they can understand the logic of audit practice, but current textbook approaches need to be modified.

Introducing the reading of ledger accounts early in the text allows instructors to talk about audit theory and concrete examples and challenging problems for resolution. This approach promises to help students see that theory is important to grasp because it supports problem solving and can be learned in relation to practical issues encountered in business environments. Such linkage, we think, supports student learning. Students' experience of connecting theory to practice through specific problem-solving exercises shows them the importance of theory and that it is useful because it shapes how the professional addresses practical issues as they arise. Having used this approach, we find that an early mix of practical and theory works well.

Change makes it difficult for a teacher to keep up with the current rules and regulations. Students do not fully appreciate how much things have changed because they don't have a long history with the profession. This book is designed to educate the teacher as well as the student. Auditing standards from three sources are listed at the beginning of each chapter: the PCAOB, the Auditing Standards Board, and the International Auditing and Assurance Standards Board. Changes to these standards will be posted to the book's website as soon as they are passed—and there will be changes. The Auditing Standards Board will soon reissue all auditing standards after they have been converged with international auditing standards. This will result in a complete renumbering of auditing standards. The PCAOB will continue to issue new standards, and the interim standards it adopted in 2003 will be revised. The book concludes with chapters on procedures performed at the end of the audit of limited companies and other concerns and audit reports and on the audit profession.

The syllabus contains a list of the topics covered in each chapter which will avoid the controversies regarding the exact scope of the syllabus. The text follows the section-wise, chapter topic pattern as prescribed in the syllabus. We have preferred to give the text of the section and rules as it is and thereafter added the comments with the intention of explaining the subject to the students in a simplified language.

While making an attempt to explain in a simplified language, any mistake of interpretation might have crept in. This book is a unique presentation of subject matter in an orderly manner. This is a student-friendly book and tutor at home. We hope the teaching faculty and the student community will find this book of great use.

We welcome any recommendation for improvements of this textbook. It is my belief that comments or suggestions for additions, deletions, corrections, rearrangements, etc. from readers will enhance future editions.

We are extremely grateful to Mr. Pandey of Himalya Publishing House Pvt Ltd for their devoted and untiring personal attention accorded by them to this publication.

We gratefully acknowledge and express our sincere thanks to the following people without whose inspiration, support, constructive suggestions this book would not have been possible.

Mr. Jitendra Singh Thakur (Trustee, Thakur College)

Dr. Chitali Chakraborty (Principal, Thakur College)

Mrs. Janki Nishikant Jha

Authors

Syllabus

Sr. No.	Modules/ Units
1	**Vouching**
1.1	Audit of Income Revenue from Sales and Services, Rental Income, Interest & Dividends Income, Royalties Income, Recovery of Bad debts written off, Commission Received
1.2	Audit of Expenditure Purchases, Salaries & Wages, Rent, Insurance Premium, Telephone expense, Petty cash payment, Advertisement, Travelling Salesmen's Commission, Freight Carriage and Custom Duties
2	**Auditing Techniques: Verification**
2.1	Audit of assets Plant & Machinery, Furniture and fixtures, Accounts Receivable, Investments, Inventory, Goodwill, Patent Rights
2.2	Audit of Liabilities Outstanding Expenses, Accounts Payable, Secured loans, Unsecured Loans, Contingent Liabilities, Public Deposits
3	**Audit and Assurance Standards**
3.1	Significance of the Audit and Assurance Standards issued by Institute of Chartered Accountants of India. Responsibility of auditor for AAS
3.2	Understanding of following standards SA 200 Basic principles of Governing an Audit SA 200A Objective and scope of the audit of financial statements SA 230 Audit documentation SA 320 Audit materiality SA 570 Going Concern
4	**Audit of Limited Companies**
4.1	Qualifications, Disqualifications, Appointments (First & Subsequent auditor), Reappointment, Removal of auditors.

Question Paper Pattern

Maximum Marks: 75

Questions to be Set: 05

Duration: 2 1 /2 Hrs.

All Questions are Compulsory Carrying 15 Marks each.

Q-1	Compulsory – No Option - Objective Type (a) Sub Question to be asked 10 and to be answer 08 (b) Sub Question to be asked 10 and to be answer 08 (True of false, multiple choice, answer in one sentence, match the Following)	15 Marks
Q-2 Q-2	Full Length Question OR Full Length Question	15 Marks 15 Marks
Q-3 Q-3	Full Length Question OR Full Length Question	15 Marks 15 Marks
Q-4 Q-4	Full Length Question OR Full Length Question	15 Marks 15 Marks
Q-5 Q-5	Full Length Question OR Short Notes To be answered 05 To be answered 03	15 Marks 15 Marks

Note: Full length question may be sub-divided into two sub question of 08 and 07 marks.

Contents

1 CHAPTER

Vouching

MEANING

After preparing Audit note book, audit planning, auditing working papers, audit preparations etc., the next step is to proceed with the examination of accounting entries passed in the books of account during the period under review. In this step the auditor has to check the entries with its supporting documents to determine the accuracy and authenticity of the entries passed by verifying the vouchers, bills and other supporting documents. This process of checking the evidence of the entries called vouching. It may relate to cash as well as trading transactions. Lawrence Dicksee had defined "vouching as an act of comparing entries in the books of accounts with documentary evidence in support thereof:"

Importance of vouching

It is often thought that vouching is mere examination of voucher with book entries but this however is wrongly considered .Vouching comprises of examination of voucher that will satisfy auditor. Not only vouchers has to be supported by conclusive documentary evidence but it has to be properly made upon books of accounts.

True and Fair

Vouching helps the auditors to ascertain whether the entries in the book are true and fair, this is the basic objective of auditing. Vouching provides audit evidence in respect of following matters:

- **Occurrence:** Vouching helps the auditor to ascertain whether the transaction has actually occurred.
- **Amount:** Vouching helps the auditor to see whether the transaction is recorded for the right amount.
- **Relevant entries:** Vouching helps the auditors to see whether the entries recorded in the books are relevant or not i.e. they relate to the concern and to the current accounting year. Through vouching, the auditors can ascertain whether the entries about the income, expenses, assets etc are relevant.
- **As per standards:** Vouching helps the auditor to verify whether the item is accounted as per the recognized accounting standards, policies and practice.
- **As per law:** Vouching complies the transaction is according to law. E.g. companies law, income-tax act.

- **Disclosure:** Vouching enables the auditor to ensure that the item is properly disclosed in the final accounts as required by schedule VI of Companies' Act 1956.

Points to be considered for vouching

Voucher is a document which authorizes an entry into books of accounts. In addition, the voucher may also act an authorization of carrying out actual transaction requiring entry in book of accounts.

1. All vouchers should be consecutively numbered and filed properly.
2. Each voucher should be dated and such date should fall within the financial year under audit.
3. Voucher should be addressed to the client and should relate to business of the client.
4. The amount shown on vouchers should be calculated accurately and amount in words and in figures should match.
5. The signature of the official authorizing the transaction is there on the voucher.
6. Vouchers are properly affixed with a revenue stamp as per the requirements of law.
7. Vouchers originating outside the business are genuine.
8. In case of missing vouchers, the auditor should ask for the reasons for the same & should rely on appropriate evidence, in case of a missing purchase invoice; he may obtain a duplicate copy from the client.
9. The auditor should not seek help of the client's staff while vouching.

Vouching of Income/Receipt

General consideration

Off all the company assets Cash is the most liquid and therefore potentially the most attractive to defalcators. Because of its high liquidity, the cash accounts should always receive the auditor's careful attention. Therefore it is duty of the auditor to check that cash transactions entered into the books are correctly recorded and all required procedures are fooled properly.

To verify cash transactions, it is necessary:

1. To verify the system of internal control
2. To check whether all transactions are correctly recorded
3. There is documentary evidence for every transaction.
4. Proper disclosure of these transactions is made in financial statements.
   - Procedure for audit of receipt

Checking receipt and entry in the books of accounts:

1. **Name of client:** Auditor should check that name of the client in the cash book and name of the client on the receipt is same.
2. **Date of vouchers:** Auditor should see that date on the voucher and date of entry in the cash book are same and fall in the current accounting year
3. **Serial number of vouchers:** It should be in continuation.

4. **Amount in words and figures:** auditor has to confirm that amount written on the voucher in words and in figures is the same he also has to ensure that the same amount is entered in the cash book.
5. **Head of account:** auditor should ensure that the entry of the voucher is made under proper head of account. It should be same in the voucher and in the books of account.
6. **Signature of person preparing voucher:** this help to fix the responsibilities for any errors in the voucher
7. **Signature of the receiver:** this is the proof that the amount was actually received by the concern. The signature should be on revenue stamp if the amount exceeds Rs. 500.

Cash Sales

Cash Sales are sales of goods and services where cash is collected at the time goods or service is supplied. Cash sales include cash and GST collected for such things as user or registration fees for conferences, field trips, camps or memberships. Cash Sales units need to comply with the Cash Sales Procedure and Cash Receipt and Banking procedures.

Payment for Cash Sales can be in the form of currency (bank notes and coin), cheques, bank drafts, money orders, credit and debit cards, or Electronic Funds Transfer (EFT).

Vouching of Cash Sales

Cash sales can be vouched by the auditor in the following way:

1. **Internal Check:** Auditor should evaluate the internal check and if it is proper system then he should rely on it.
2. **Checking of Memos:** Auditor should check the cash sales memos and compare it with the daily summaries of salesman and cashier.
3. **Entry in Cash Book:** Auditor should also check the figures of the salesman and cashier summaries entry in the cash book.
4. **Checking of Cash Register:** If cash register is used, auditor should check the total daily rolls with the entries in the cash book.
5. **Checking of Cash Book:** Auditor should compare the cash book with the general ledger.
6. **Checking of Price Lists:** Auditor should obtain and verify it price lists and other instructions by the authorize persons regarding the cash sales.
7. **Guidance to Client:** If internal check system is not effective than auditor should inform the client about the dangers of frauds. He should also suggest some measures.

Sales on Approval

1. **Document to be seen (Sale or return day book):** Examine the sale or return day book for the manner of accounting.
2. Check actual movement of goods from dispatch register/goods outward book. Note the period of approval in the case of different goods/customers.
3. Verify whether goods returned have been properly reversed in the day book.
4. Order book or confirmation book:-Examine this register to verify sale confirmed by customers and goods held by customers at their end as sale or return stock.

5. Sales register Ensure that sales have been recognised whenever- (a) approval is received from the party: or (b) goods are appropriated by the party; or (c) period of approval has expired and goods have not been returned.
6. Stock registers and statements: Ensure that closing stock includes goods lying with customers in respect of which period of approval has not expired.
7. Ensure that goods validly returned by customers are duly accounted in stock.

Consignment Sales

1. Document to be seen (Consignment agreement):- Ascertain and note the following terms and conditions like commission due, manner of payment, adjustment, etc.
2. Risk of bad debts- in case of del—credere commission:- consignee has to bear the risk of bad debts; else bad debts are borne by the consignor.
3. Reimbursement of consignment expenses.
4. Goods outward book: Verify goods despatched by reference to the proforma invoice, consignment day book, goods outward book, transport documents, acknowledgement of the goods by the consignee and the account sales.
5. Stock registers: Ensure that the stock lying with consignee at the year end is taken in the balance sheet at cost on a consistent basis and credited to the consignment a/c to arrive at the result of consignment transactions.
6. Ensure that no profit is taken for the profit on goods remaining in the hands of the consignee.
7. Account sales: Verify whether consignment sales are accounted by crediting consignment account and debiting the consignee's account.
8. See whether the summary of transactions reported i.e. sales made, expenses incurred, commission due, remittance made, balance stock, and amount due from/to either party is properly disclosed in the general ledger.
9. Consignment account: When the goods are consigned above cost, ensure that necessary adjustments to remove the loading are made at the end of the year.
10. Verify whether necessary adjustments are made at the year – end in respect of unsold goods, commission and expenses incurred by the consignee.
11. Confirmation: Obtain confirmation of the account balance from consignee.

Recovery of Bad Debts written off

(i) Ascertain the total amount of bad debts.

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

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

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

Sales Return

(i) Examine the accounting basis for such transactions with reference to corresponding Debit Note. The relevant correspondence may also be examined.

(ii) Verify by reference to relevant corresponding record in goods inward book or the stores records. Further, the figures in these documentary evidences should be compared with the original invoices for rates and other charges and calculation should also be checked.

(iii) Examine in depth to eliminate the possibility of fictitious sales returns for covering bogus sales recorded earlier when such returns outwards are in substantial figure either at the start or end of the accounting year.

(iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.

Rental Receipt

(i) Check the copies of the bill issued to the tenants by reference of copies of the tenancy agreements and bill of charges paid by the landlords on behalf of the tenants.

(ii) The amount collected from the tenants on account of the rent should be checked by the reference to receipt issued to them.

(iii) At the end the register should be scrutinized to find amount or rents which are not recorded and are considered bad or irrecoverable, for deciding whether these should be written off.

(iv) Verify the particulars of total accommodation available for being let out in different building or belonging to the client.

Commission Received

Auditor should check the following points:

(i) **Supporting documents:** The commission received should be supported by- (1) copy if the bill of the client (2) copy of agreement showing rate of commission.

(ii) **Name:** Name of the concern on the bill on the receipt registered and in the supporting document should be of the client.

(iii) **Date:** Date on the bill in the receipt registered and in the supporting document should tally and pertain to the current year.

(iv) **Sr. no:** Serial number on the bills should be continuous and tally with those in the books.

(v) **Amount:** Amount in figures and words on the bills should be the same and tally with the amount in the books and the supporting documents

(vi) **Rate/amount:** The rate/amount mentioned in the bills should tally with the supporting documents and the entry in books.

(vii) **Signature on bills:** The bills should be signed by (a) an authorized of the official of the client to indicate the approval and (b) the person preparing the bill and the person making entry in the register so as to fix the responsibility for any error

(viii) **Errors and frauds:** Auditor should ensure that there are no errors of commission or omission. He should pay particular attention to the transction close to the year-end; i.e.

the cut-off date. Auditor should note the amount and the rate of commission for overall reconciliation.

(ix) **Proper accounting:** Auditor should see that commission received is properly accounted in the books. The amount in the bills should be debited to cash /bank or party and should be credited to miscellaneous income and not to the sales A/c.

Interest and Dividend received

1. First check the income stated in the current year's profit and loss account.
2. Ascertain the amount received on account of last year and find the outstanding balance receivable.
3. From cash book vouch the entries for income received.
4. Check the Tax Deducted at Source (T.D.S.) calculation and verify the effect given in the ledger.
5. Compare the income received in total with that of the last year and enquire about any significant variation.
6. Get a list of investments and check whether the income on all the securities and investments has been received. If any securities are pledged with bank, get a certificate from bank.
7. Ascertain the income for the year, still to be received and check whether provision has been made for the same.
8. In case of interest received check the calculations.
9. For interest from bank, verify the entry in the bank statement. For fixed deposits, check whether any F.D has matured or any F.D. newly kept.

Royalties received

1. The auditor should see the relevant contract and examine the important provisions relating to the conditions of payment of royality. In particular, the rate of royalty, mode of calculation and the due dates should be noted.
2. The periodical statement received from the publisher and the calculation of the royality should be checked. If there is any deduction on account of recoupment of royality for the past period, the records for earlier royality receipts should be seen to ensure that the amount of deduction is as per the contract.
3. Royalties due but not yet received should have been properly accounted for.

Vouching of Expenditure

General Considerations

In any business, cash transactions forms the largest bulk of transactions. However, there is maximum scope for frauds in these transactions. Therefore it is duty of the auditor to check that cash transactions entered into the books are correctly recorded and all required procedures are followed properly.

To verify cash transactions, it is necessary:

1. To verify the system of internal control

2. To check whether all transactions are correctly recorded
3. There is documentary evidence for every transaction.
4. Proper disclosure of these transactions is made in financial statements.

Procedure for Audit of Payments

Checking vouchers and entry in the books of accounts:

1. **Name of client:** Auditor should check that name of the client in the cash book and name of the client on the voucher is same.
2. **Date of vouchers:** Auditor should see that date on the voucher and date of entry in the cash book are same and fall in the current accounting year
3. **Serial number of vouchers:** It should be continues.
4. **Amount in words and figures:** Auditor has to confirm that amount written on the voucher in words and in figures is the same he also has to ensure that the same amount is entered in the cash book.
5. **Head of account:** Auditor should ensure that the entry of the voucher is made under proper head of account. It should be same in the voucher and in the books of account.
6. **Signature of person preparing voucher:** Once voucher is prepared, it has to be signed immediately by the person preparing it. This helps to find out the person who made error preparing the voucher.
7. Signature of authorized by the proper officer having authority to do it. It should bear signature of that officer. This proves that entry is valid and genuine.
8. **Signature of the Payee:** Voucher should have signature of the payee. This is a proof that the amount was actually received by the client.

Audit of Payments of Specific Transactions:

Purchases:

1. **Supporting documents:** Purchases can be either in cash or on credit. Cash purchases should be verified with (a) cash memos or (b) invoiced received from supplier

   In case of imported goods, import license, bill of entry, custom duty receipt etc can be checked by the auditor
2. **Name of client:** Name of client i.e. name of the concern for whom purchases are made should be same on invoices, purchase day book as well as on any other supporting document.
3. **Date:** Like the name date of invoices ,purchase day book and any other supporting document should be same
4. **Serial Number:** Serial numbers on purchase vouchers should be continuous and should tally with those entered in Purchase register.
5. **Amounts:** Amounts written on vouchers in words in figures should match .They should tally with amount entered in the books of account as well as with any other supporting document.

6. **Quantity:** Quantity entered in the Purchase book should tally with supporting document i.e. delivery challan, transporter's bill, octroi receipt, entry in the Stock Books etc.
7. **Signatures on vouchers:** The purchase vouchers must be signed by.
   (a) Authorized officer of the client.
   (b) Person who prepares the voucher and
   (c) Person making entry in Purchase day book.

   This will help in recognizing at what point and by whom error or fraud is made.
8. **Signature and stamp of the client:** The purchase bill received from the client should have signature and stamp or seal of the client.
9. **Distinction between Payment of goods and an advance:** It is necessary to make distinction between payment for goods and an advance against supplies to be made in future.
10. **Errors and frauds:** Auditor should ensure that there are no frauds and errors in the books as well as in the invoices. There are no errors of omission as well as commission.
11. **Purchase Return**
12. (i) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.
13. (ii) Verify by reference to relevant corresponding record in good outward book or the stores records. Further, the figures in these documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.
14. (iii) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.
15. (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

Wages and Salaries:

Vouching of Salaries:

While vouching salaries auditor should pay attention to the following points:

1. The auditor should check the salary book.
2. He should check the salaries actually paid during the year.
3. He should compare the salary book and cheque drawn for a particular month.
4. He should compare salary book with the cash book.
5. Auditor should see that sign of each employee are available on the book.
6. Auditor should also examine, terms and conditions of the officers employment.
7. Revenue receipts should also be checked by the auditor.

8. Auditor should also verify that all the deductions like income tax, and other funds have been credited in the irrespective accounts.
9. He should also check that unpaid salaries are taken into account for that period.
10. Auditor should also check that increment given to the employee was due or not.

Vouching of Wages:

To vouch the wages following points must be considered:

1. **Checking of Internal System:** Auditor should satisfy himself testing the system of internal check that internal control system is sufficient to provide a reasonable protection against errors.
2. **Checking of Calculations:** Auditor should apply the test check to see that all the calculations are correct.
3. **Checking of Wages Sheet:** Auditor should examine the time work wages and piece work wages thoroughly.
4. **Computing System:** Auditor should check that wages computing paying system is sound or not.
5. **Nature of Payment:** The nature of payment in both the cases (time and piece of work) must be checked by the auditor that it is actually in practice or not.
6. **Same Cash paid and Drawn:** It should be also checked by the auditor that amount paid should be same which is drawn.
7. **Checking of Names:** Auditor should check that payment has been made to those, employees whose names are given. He should check that there should be no dummy worker in them.
8. **Proper Signature:** He should check that wages sheets should be properly authorized and signed by the reasonable officer.
9. **Signature Verification:** Auditor should verify signature and thumb impressions of workers by using the test check. He can compare with previous month.
10. **Unpaid Wages:** He should check that all unpaid wages are taken into account or not.
11. **Deductions:** Auditor should also check that deductions like income tax are properly made in their relative heads.

3. Advertisement Expenditure

(a) Supporting documents:

1. Bill from the advertising agency
2. Proof of appearance of advertisement from the concerned medium,
3. Contract with the advertising agency about the terms and conditions

(b) Relate to clients business only: The advertisement expenses should be related to client's business only

(c) Date of advertisement: The advertisement should have appeared in the current financial year only.

(d) **Amount:** Total amount spent for advertisement expenses be verified from the receipts from the medias or advertisement agency

(e) **Detailed about appearance of advertisement:** The auditor should obtain the complete list of advertisement, media wise i.e. Newspapers, television, magazines, radio etc. showing the dates, exact location, timing etc. along with amounts paid in respect of each category.

(f) **Regular contracts:** If there is regular contract for advertisement with ad agency. Auditor should check regular statements obtained from the agency showing the advertisement made and amounts debited to the client

(g) **Accounting Principles and practices:** The auditor should check that while recording the payment for advertisement expenses basic accounting principles are followed properly. E.g. classification of heavy advertisement expenses into capital and revenue expenditure, pre-paid and outstanding expenses, Etc.

(h) **Disclosure:** The auditor sees that outstanding advertising expenses have been properly disclosed on the laities side of the balance sheet.

Rent expense

1. **Rental Agreement:** Examine the Rent Agreement and note aspects like - (a) period of lease; (b) rent payable; (c) manner of payment; (d) amenities and other charges payable etc.
2. **Payment Vouchers:** Verify the payment vouchers and check whether the payments have been made as per the terms of the agreement.
3. **Bank Statement:** Trace the payment entries into the Bank Statement.
4. **Receipts:** See whether proper receipts have been obtained from the owner of the property.
5. **TDS File:** In case of rent payments exceeding Rs. 1, 80,000 per annum, see whether tax has been deducted at source at the appropriate rates, and remitted to the authorities. See whether Tax deduction Returns have been submitted to the IT Authorities.
6. **General Ledger/Financial Statements:** Ensure that any payment in the nature of Deposit/Additional Deposit has not been wrongly charged to revenue. Where the Deposit given to the Landlord bears any interest, see whether interest income has been recognised in the P&L A/c. Scrutinise the Ledger and see whether proper accounting entries have been passed in respect of Prepaid Rent as at the beginning of the year/Rent Payable at the end of the year etc.

Insurance Premium

1. **Document to be seen (Insurance Policy/Cover Note):** Examine the insurance policy;/ cover note and note aspects like – (a) asset covered by the policy; (b) amount of premium; (c) time period of insurance, etc.
2. **Bonus:** See whether “No Claim Bonus”, whether applicable, has granted in the policy to the insured.
3. **Payment vouchers:** Verify the payment vouchers and trade the payment entries into the blank statement. Compare the same with receipt issued by the insurance company.

4. Arrangement with the bank Examine cases of insurance premium payments where insurance policy is taken out by arrangement with the bank e.g. in case of machineries and other assets obtained by way of bank loan.
5. **Staff insurance policy records:** Where insurance premium relates to staff, examine whether the same has been properly recovered monthly/periodically from their pay bills.
6. **General ledger/financial statements:** Scrutinize the ledger and see whether proper accounting entries have been passed in respect of prepaid insurance as at the beginning of the year/unexpired insurance premium at the end of the year etc.

Petty Cash Expenses

1. **Internal Controls:** Examine the Internal Control in respect of Petty Cash Payments, and note the authorization procedure in respect of Postage and Courier Expenditure, Postage Stamps/Prepaid Post Covers, etc. Identify the persons who handle Petty Cash. Verify the ceiling limit of disbursement through Petty Cash. Note the limit of Imprest System.
2. See whether such controls have operated effectively over the Petty Cash Book. Examine the Petty Cash Book and test-check the entries relating to Postage Courier Expenditure, for a few months
3. Vouch the expenditure with respect to supporting documents like dispatch Register. Cross-check a few cases of Postage/Courier Expenses with the dispatch Register/ Outward Mail Register to see whether any mail has been sent on that day.
4. **Acknowledgements:** Where Postage Expenses are recorded in respect of Registered Post/Speed post. Examine a few cases whether these "Acknowledgement are being received from the parties.
5. **Agreement with Courier Company:** Where agreements are entered into" with a Courier Company/Agency settlement of bills on a monthly basis, see whether the internal control procedure for authorizing payments (at the month end) is operating effectively.
6. **TDS:** See whether TDS has been deducted at source and remitted properly where amount of the contract exceeds Rs.20, 000.
7. **General Ledger/Financial Statements:** Verify whether year-end adjustments have been properly accounted in respect of Postage Stamps in Hand.
8. Compute the percentage of Postage Expenditure to Total Turnover and compare tell same with that of previous year.
9. Examine Reconciliation Statements prepared regularly for Petty Cash, based on vouchers.
10. Check the castings of columns, totals and main totals. Trace the postings from the Petty Cash Book into the Nominal Ledger Head of Account.
11. Examine the Suspense Vouchers/lOU's and ensure that they are reversed within a reasonable time.
12. Conduct a Surprise Check of Petty Cash balance and compare the same with the Petty Cash Book.

CUSTOM DUTIES

Actions	Customs Duty
Type of voucher	Bank/Cash payment voucher
Verify the voucher date	To ensure that the transaction pertains to current year
Verify the serial No.	To ensure that no voucher is missing in between
Verify the Account head	Dr. Customs Duty A/c. Cr. Bank/cash Cr. Customs Duty Drawback Receivable a/c. (if any)
List of supportive documents	Bill of entry, Custom Clearance Certificates, C&H agents documents, Port charges, Challan of customs duty, Warehouse receipt. Copy of DEPB or Advance Licence.
Computation	Computation should be done with reference to
Authorised by	Manager Accounts
Books of Accounts to examine	Cash/bank book, ledger.
Accounting Policy	Customs duty payable shall be adjusted against duty draw back and export incentives.

OBJECTIVE QUESTIONS

A. State with reasons whether following statements are true or false.

1. Process of checking the evidence of the entries called vouching.
2. All vouchers should be consecutively numbered and filed properly.
3. Verification helps the auditor to ascertain whether the transaction is actually occurred.
4. Name of the client in the cash book and name of the client on the receipt is should not be same.
5. Serial number of vouchers should be continuous.

Ans: True: 1, 2, 5.

False: 3, 4.

B. Match the following

Sr. No	Column A	Sr. No.	Column B
a	Vouching	i	Debit notes from customer.
b	Sales	ii	Salary register
c	Amount	iii	Process of checking the evidence of the entries
d	Salary	iv	Cash memo
e	Purchase	v	amount in words and in figures should match.

Ans: a (iii), b (iv), c (v), d (ii), e (i)

Multiple Choice Questions

C. Select the most appropriate answer from the following:

1. Process of checking the evidence of the entries called _____________.
   (a) Verification
   (b) Observation
   (c) Vouching
   (d) Inspection

2. To verify cash transactions, it is necessary
   (a) System of internal control
   (b) Check all transaction
   (c) Documentary evidence for every transaction
   (d) All of the above.

3. Total amount spent for advertisement expenses be verified from the
   (a) Receipts from the Medias or advertisement agency.
   (b) Fixed assets register
   (c) Debtors books
   (d) None of the above.

4. Vouching helps the auditors to ascertain whether the entries in the book________________ , this is the basic objective of auditing.
   (a) True and fair
   (b) Only true
   (c) Only fair
   (d) None of the above.

5. Voucher should be addressed to the ____________.
   (a) Auditor
   (b) Client
   (c) Employee
   (d) None of the above

6. Serial number of vouchers should be ____________.
   (a) Colored
   (b) Continuous.
   (c) Even number
   (d) Odd number.

Ans: 1. (c), 2. (d), 3. (a), 4. (a), 5. (b), 6. (b).

ADDITIONAL OBJECTIVES

A. State with reasons whether following statements are true or false.

1. When the goods are sent to an agent on consignment basis, sales should be booked when the goods are actually sold by the consignee.
2. Checking the date on the supporting documents is not at all important.
3. Auditor should ensure that the value of goods returned is disclosed separately in the profit and loss account.
4. The amount mentioned on the voucher has to match with the amount in supporting documents and also the books of accounts.
5. If tax is deducted at source (TDS) from interest, auditor should see that interest is shown in the account net of TDS.
6. The auditor should reconcile the sales register and stock register to ensure that the goods sold are actually removed from the godown.
7. In case of rent income, the same has to be disclosed as a "operating income".
8. Every voucher need not be authorized.
9. While vouching dividend received, the auditor has to verify the schedule of investments.
10. Auditor should ensure that remuneration to directors is disclosed separately

Ans: True: 1, 4, 9, 10.

False: 2, 3, 5, 7, 8.

B. Match the following

Sr. No	Column A	Sr. No.	Column B
a	Importance of vouching	i	To be disclosed under "Revenue from operations"
b	Authorization	ii	Points to be considered while checking voucher
c	Sales	iii	Signature of payee on revenue stamp
d	Income from investments	iv	To be disclosed under "Other income"
e	Cash payment exceeding Rs.5000	v	Dividend from official Receiver
		vi	Proper accounting

Ans: a (vi), b (ii), c (i), d (), e (iii).

C. Fill in the blanks with proper word.

1. __________________ means comparing the entries in books of accounts with documentary evidence in support thereof.
2. While auditing interest expense, the auditor has to ensure that the name of __________on the loan agreement is that of the auditee.

3. In case, interest is received net of TDS, interest should be recorded in the books at ____________
4. Companies are required to maintain accounts as per ____________
5. The payee should sign on a ____________ stamp, if the payment exceeds Rs.5,000/- .

Ans: (1) Vouching, (2) Borrower, (3) gross value, (4) Revised Schedule VI format, (5) Revenue

D. Select the Correct answer

1. Which of the following is an importance of vouching?
   (a) Ensures all items are disclosed in the financial statement as per Schedule VI provisions
   (b) It helps to verify whether entries are passed as per acceptable accounting principles.
   (c) Helps in detection and prevention of errors & frauds
   (d) All the above
2. Checking the head of account debited or credited during vouching helps the auditor to
   (a) Detect errors of principle
   (b) Check whether accounting is proper.
   (c) Find errors of commission
   (d) All of the above
3. Which of the point is not to be considered while checking a voucher?
   (a) Name of party
   (b) Serial number of voucher
   (c) Credit period of payment
   (d) Accounting entry
4. Which of the following can be accepted as a supporting document?
   (a) Invoice/Challan
   (b) Debit note/Credit note.
   (c) Emails/letters.
   (d) All of the above.
5. Checking the date of voucher on the voucher during vouching mainly helps the auditor to obtain evidence that.
   (a) The transaction relates to current year.
   (b) The transaction has taken place.
   (c) The transaction is genuine.
   (d) The transaction is legal.

6. While verifying recovery of bad debts, the auditor has to check
   (a) Whether the amount was actually written off in some previous year
   (b) The source of income of the debtor
   (c) That the debtor has returned the entire amount written off.
   (d) All of the above.
7. The auditor does not have to check the following while auditing salaries or wages:
   (a) Calculation of the salary
   (b) Whether the calculation was verified by department heads
   (c) Whether dues like PF, PT, TDS have been deducted and deposited
   (d) Payment has been made to all the employees on first of the month
8. Checking the date of entry of voucher in the books mainly helps auditor to obtain evidence that:
   (a) Entry was made on the same day as that of the voucher.
   (b) Entries are passed on a daily basis
   (c) The vouchers are filled every day.
   (d) No vouchers are missing
9. In order to audit petty cash expenses, the auditor has to check
   (a) Petty cash register
   (b) Internal controls
   (c) Reconciliation of petty cash register and cash book
   (d) All of the above.
10. In case of sales return, the auditor should check.
    (a) Credit notes and delivery challans.
    (b) Whether cash has been repaid to the client
    (c) Purchase invoices and goods received notes.
    (d) Credit notes and goods received notes.

Ans: 1. (d), 2. (a), 3. (c), 4. (d), 5. (a), 6. (a), 7. (d), 8. (a), 9. (d), 10. (d)

Theory questions:

Explain the following:

(a) Explain the term vouching.
(b) Explain the term true and fair in respect to vouching.
(c) List out the important point while considering for the vouching.
(d) Explain the procedure for the audit of receipt.

(e) Explain the vouching of cash receipt.

(f) Write short note on vouching of Rental receipt.

(g) Write short note on vouching of commission received.

(h) What are the general considerations for vouching of expenditure?

(i) What are the procedures for the audit of expenditure?

(j) What are the points to be considered for purchase?

(k) Explain the vouching of salary.

(l) Explain the vouching of wages.

(m) List out the important point while vouching advertisement expenditure.

2

CHAPTER

Verification

MEANING

It means confirmation or proving the truth about the assets and liabilities appearing in the balance sheet. Auditor has not only to check the arithmetical accuracy of the account by vouching only. He has also to verify the assets and liabilities appearing in the balance sheet to satisfy him that these are correct. Auditor will also check that the existence of actual items and their actual possession held by the company concern.

Objects of Verification

The object of verification of asset is the satisfaction by the auditor as to its existence, proper disclosure, proper valuation, correct ownership on the balance sheet.

Techniques of Verification

In the process of verification following techniques are used:

1. **Existence:** The auditor should satisfy himself that such assets and liabilities which are shown on the balance sheet really exist on that date or not.
2. **Proper Disclosure:** The auditor should also satisfy himself that each item of assets and liability is being properly disclosed as required by the law.
3. **Ownership:** This technique is used for establishing the ownership of assets and liabilities. Those assets which are shown on the balance sheet must be properly of the client.
4. **Possession:** The auditor should satisfy himself that such assets which are shown on the balance sheet were in the possession of the client at the date of the balance sheet.
5. **Valuation:** Auditor should also satisfy himself that all those assets or liabilities which are shown in the balance sheet are properly valued. There are different factors which determine the basic of valuation like, nature of business, object for which the assets are held and the nature of assets.
6. **Correct Valuation:** Auditor should pay special attention to this point. Because profit and loss account also depends upon the accuracy of valuation of assets and liabilities. Valuation up to object is that balance sheet should show a true and correct view about the financial position of a client firm.

7. **Purchase by Proper Authority:** The auditor should also satisfy himself that the purchase of any particular asset was made by the orders of empowered person. In this respect, auditor may check the legal document or resolutions of the directors and shareholders.
8. **Business Motive:** Auditor should also satisfy himself that all the assets were obtained for the business motive of the firm.
9. **Checking of Charges:** Auditor should also examine that assets of the firm are free from mortgage and pledge.

Vouching and Verification

Sr. No	Vouching	Verification
1	Vouching is the act of checking the records with the help of evidential documents.	Verification is the act of checking title, possession and valuation of assets
2	Vouching is related to all the accounting documents.	Verification is specially related to the assets and liabilities
3	Vouching is the substantive testing/examination of transaction at their POINT OF ORIGIN	Verification usually deals with the FINAL BALANCE in the Final Accounts viz the balance sheet and profit and loss
4	Generally, assistant staff or auditor performs the work of vouching	Auditor himself performs the work of verification.
5	Vouching is made at the beginning of auditing	Verification is made at the end of auditing or at the time of checking balance sheet.
6	Is a substantive audit procedure which deals with examination of profit and loss transactions/items	Is a substantive audit procedure which deals with examination of balance sheet transactions/items whether they are assets or liabilities are properly stated in the balance sheet

Valuation

Valuation of assets means determine the correct value of the assets shown in the balance sheet.

There are some points to be considered while valuing the assets they are as follows:

1. **Method of valuation:** auditor should ensure that the organization or he himself method which is followed is proper and recognized by various laws.
2. **Consistency:** Method which auditor follow should be consistent from one year audit to another year of audit.
3. **Calculation:** Auditor should see that the management has done proper calculation for valuation of assets and liabilities.
4. **Revaluation:** Whenever the asset or liabilities is revalued the audit has to see its basis and value are properly accounted. The auditor has to see that the revaluations are properly disclosed.

5. **Foreign Exchange:** In case of foreign exchange the auditor has to see that amount are properly converted into Indian rupees.
6. **Accounting Practices:** Guidelines which are issued at ICAI or other legal bodies should be properly followed by valuing the assets.
7. **Legality:** The provisions of companies act are properly followed while valuing the assets and liabilities.
8. **Audit Report:** Under Caro Auditor has to see that the valuation of assets and stock are done properly.
9. **Event after balance sheet date:** The auditor has to see that whether any event occurs after balance sheet date has affected valuation.

Patent

1. The ownership of patent rights is verified by inspection of certificate issued for grant of patent, by the prescribed authority.
2. If it has been purchased, the agreement surrendering it in favour of the client should be examined.
3. If there are a number of patents held by the client, obtain a schedule giving the full details thereof or verify with reference to the register maintained by the client.
4. It must be verified that patent rights are alive and legally enforceable and renewal fees have been paid on due dates and charged to Revenue Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed.
5. See that the patents are properly registered in the name of the client only.
6. See that the cost of patent is being written off over its useful period of life.
7. In case the patent is acquired, cost paid for the same and all relevant expenses are to be capitalized.
8. If the patent is created by the client by the research experiments and laboratory work, only the actual expenses incurred for it in the process are to be capitalised.

Investments

Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc. For verification of such securities, the following procedure is adopted.

1. Obtain a schedule of investments in hand at the beginning of the audit period.
2. Obtain the details of description of investments together with distinctive number of face value, date of purchase, book value, market value, rate of interest, date of payment of interest or, date around which dividend is declared, etc., with also the details of interest or dividend received along with tax deducted at source.
3. Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.
4. Balance this schedule and compare the balance with general ledger and Balance sheet.

5. Check the market value of investments with reference to stock exchange quotations or other suitable method, on Balance Sheet date and see that the values are disclosed in the Balance sheet.
6. Inspect the certificates or securities physically on the Balance Sheet date.
7. Compare the income received with amount due and adjust the accrued income.
8. Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the Balance Sheet.
9. See that adequate provision is made for any shortfall in the book value of investment shown in the Balance Sheet.
10. See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.
11. For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.
12. Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.
13. For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.
14. In case of application money paid for shares which are still to be allotted, that fact is to be specially disclosed in the Balance Sheet.

Goodwill

1. Whenever the company has purchased or acquired a running business and has paid for it an amount, in excess of the book value of its net assets, the excess is called `Goodwill'. It can be verified from the vendor's agreement and the auditor has to see whether there is a specific sum which is paid or whether it is the excess of price paid over the tangible assets and see that it is properly recorded.
2. When the company has written up the values of all its assets on a revaluation and has raised a Goodwill Account in the books, the Goodwill appears in the Balance Sheet. In this case, the auditor has to see the basis of valuation and get satisfied about the same. If he is not satisfied, the fact should be reported to the shareholders.
3. He has to see that such excess is credited to a Capital Reserve or Revaluation Reserve and no dividend is being declared from it.
4. He has also to see the disclosure requirement of Schedule VI and ensure that the fact are disclosed for 5 years subsequent to the date of revaluation.
5. Sometimes, Goodwill which is written off earlier may be brought back in the books of account to adjust the debit balance of Profit and Loss account. In this case, the auditor should investigate the fact and satisfy in full before approving such method of creating Goodwill. He should also refer to the board resolution. In case he is not satisfied, the fact should be reported to the shareholders.

6. If Goodwill has been created by any other means, the auditor should see that all relevant facts are properly disclosed and are supported by documentary evidence.

Plant and Machinery

1. Now-a-days as per provision of Section 227(4A) of the Companies Act, 1956 every company is required to maintain a Fixed Asset Register showing full particulars including cost, location, depreciation, details of purchase, expenses capitalised, etc. Therefore, the auditor should ask for such a register maintained by the client and see that all items of plant and machinery are recorded properly giving full details.
2. As per the provision of the same section, all fixed assets are required to be physically verified by the management. Therefore, the auditor should enquire whether such physical verification was undertaken or not. If yes, he should ask for necessary papers pertaining to the same. If there is any discrepancy, reasons for the same should be asked.
3. Any new purchase made during the year are to be verified with reference to purchase invoice and other papers regarding installation of the same.
4. Total value of plant and machinery as shown by Fixed Asset Register should tally with ledger account maintained in the financial books.
5. Where any item of plant and machinery is sold, scrapped or transferred the auditor should check relevant entries for the same and verify that they are removed from the Fixed Assets Register.
6. The auditor should verify that adequate depreciation is provided on all items of plant and machinery and method of depreciation is consistently followed from year to year.
7. Auditor should see that the entire plant and machinery stands in the name of the client and are free from any charge or encumbrances. If plant and machinery is mortgaged, then he has to verify that the documents are properly executed and mention of mortgage is made in the Balance Sheet.

Furniture and Fixtures

1. The auditor has to see that a proper record showing quantitative details of furniture and fixtures owned by the client is maintained.
2. The auditor has to see that all expenses incidental to the purchase of furniture and fixtures is capitalised along with the purchase price paid for it.
3. The auditor has to enquire whether the furniture and fixtures have been properly insured or not.
4. The auditor has to see that adequate provision for depreciation on furniture and fixtures is made.
5. The auditor if possible can go for physical verification of furniture on test check basis or he can rely on the management certificate to that effect.
6. He has to further see that any damaged or unusable furniture, if existing, is fully written off in the books.

Debtors Balances/Accounts Receivable

Following points should be considered during verification of Debtors Balance:

(i) Obtain confirmation from debtors.

(ii) Verify debts with reference to cash received since year-end.

(iii) Check accuracy and completeness of debtors' listing.

(iv) Check book-keeping in small sample of ledger accounts.

(v) Check postings and enquire into unusual entries in the control account.

(vi) Verify nature, amount and classification of credit balance.

(vii) Check transaction of foreign currency balances.

(viii) Review post year-end credit notes.

(ix) Enquire into debtor balances cleared by journal entries after the year-end

(x) Consider un-provided claims, enquire and review correspondence.

(xi) Check credit note cut-off, if material.

(xii) Consider adequacy and check bases and calculations of provisions for rebates

(xiii) Verify existence and title to bills receivable, trace proceeds.

(xiv) Consider whether results of work on cutoff affect debtors.

(xv) Review audit work on income.

Confirmation from Debtors:

Through verification of debtor's balances by direct communication the auditor obtains information regarding:

(i) Adequacy of the system of internal control over sales, debtors, and collections;

(ii) Accuracy of accounting records in general and of cut-off procedures for balance sheet purposes in particular; and

(iii) Irregularities such as teeming and lading, overdue balances & incorrect balances.

The above information helps an auditor to form an opinion regarding:

(a) Reliability of debtors balances; and

(b) Quantum and nature of disputes existing between the company and its customer.

Methods of obtaining Debtors Confirmation:

(i) Positive Method. Under positive method the company requests the debtor to confirm his indebtedness to the company direct to the auditor and in case of disagreement he is also required to state the balance as per his records and provide the auditor with full particulars of the difference.

(ii) Negative Method. Under negative method the company requests the debtor to communicate with the auditor only if he disagrees with the balance. If no communication is received within specified time the auditor may assume that the balance is agreed.

Distinguish between Positive and Negative Confirmation:

(a) In positive confirmation, the debtor has to confirm the balance direct to the auditor whether he agrees while or not. In negative confirmation, the debtor has to confirm the balance to auditor only if he disagree with balance.

(b) In positive confirmation if no reply is received the auditors have to adopt other procedures to verify those balances. In negative confirmation if no reply is received the auditor may assume that the balance is agreed.

(c) Positive confirmation is preferred when the internal control system is not satisfactory. Negative confirmation is preferred when the internal control system is satisfactory or when confirming a large number of small balances.

(d) Confirme significant balances due from debtors under positive confirmation. Confirme a large number of small balances under negative confirmation.

Other procedures if reply is not received to Positive Confirmation

When no reply is received to a positive confirmation the auditor should carry out the following procedures:

(i) Check the outstanding balances as of balance sheet date have been subsequently received.

(ii) If subsequently not received then examine sale order, dispatch note, invoices and relevant documents

Stock/Inventory Verification

Verification

1. Physical verification of inventories is the responsibility of the management of the entity. Management ordinarily establishes procedures under which inventory is physically counted at least once in a year.A to serve as a basis for preparation of the financial statements.
2. When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable, due to factors such as the nature and location of the inventory.
3. If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded.
4. Where attendance at the physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation.
5. In planning attendance at the physical inventory count or the alternative procedures, the auditor would consider the following:

- The nature of the accounting and internal control systems used regarding inventory.
- Inherent, control and detection risks, and materiality related to inventory.
- Whether adequate procedures are established and proper instructions issued for physical inventory counting.
- The timing of the count.
- The locations at which inventory is held and its nature.
- Whether an expert's assistance is needed

6. When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement and the assessment of inherent and control risk at different locations.
7. When the quantities are to be determined by a physical inventory count and the auditor attends such a count, or when the entity operates a perpetual inventory system and the auditor attends a count one or more times during the year, the auditor would ordinarily observe count procedures and perform test counts.
8. When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party/arrange with the entity for sending requests for such confirmation as to the quantities and condition of inventory held on behalf of the entity. Further, depending on materiality of this inventory the auditor would also consider the following:
   - The conduct of the third party in the past with the entity and independence of the third party.
   - Observing, or arranging for another auditor to observe, the physical inventory count.
   - Obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that the inventory is correctly counted and adequately safeguarded.
   - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
9. If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count the auditor should make a reference to a scope limitation in his audit report. If the inventory is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion.

Valuation:

There are some points to be considered while valuing the assets they are as follows:

1. **Method of valuation:** auditor should ensure that the organization or he himself method which is followed is proper and recognized by various laws.
2. **Consistency:** Method which auditor follow should be consistent from one year audit to another year of audit.

3. **Calculation:** Auditor should see that the management has done proper calculation for valuation of assets and liabilities.
4. **Revaluation:** Whenever the asset or liabilities is revalued the audit has to see its basis and value are properly accounted. The auditor has to see that the revaluations are properly disclosed.
5. **Foreign Exchange:** In case of foreign exchange the auditor has to see that amount are properly converted into Indian rupees.
6. **Accounting Practices:** Guidelines which are issued at ICAI or other legal bodies should be properly followed by valuing the assets.
7. **Legality:** The provisions of companies act are properly followed while valuing the assets and liabilities.
8. **Audit Report:** Under Caro Auditor has to see that the valuation of assets and stock are done properly.
9. **Event after balance sheet date:** The auditor has to see that whether any event occurs after balance sheet date has affected valuation.

Verification of Liabilities

Introduction

- **Meaning:** Liabilities are the financial obligations of an enterprise other than owners' funds.
- **What it includes:** Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, installments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.
- **Importance:** Liabilities generally constitute a significant proportion of the total sources of funds of an entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or misstatement of liabilities vitiates the true and fair view of the financial statements.
- **Features:** An important feature of liabilities which has a significant effect on the related audit procedures is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.
- **Appropriate procedure:** In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself that all known liabilities are recorded and stated at fair and reasonable amounts.

Verification of Liabilities

Verification of liabilities may be carried out by employing the following procedures:

(a) Examination of records;

(b) Direct confirmation procedure;

(c) Examination of disclosure;

(d) Analytical review procedures,

(e) Obtaining management representations.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls.

Secured Loans and Borrowings:

1. **Borrowing power:** The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.
2. **Examination:** The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.
3. **Reconciliation:** In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.
4. **Important term:** The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.
5. **Complies:** Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.
6. **Classification:** In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.
7. **Short term loan:** Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.
8. **Installment due:** Where installments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g., in parentheses or by way of a footnote), the auditor should verify the correctness of the amount of such installments.
9. **Hire purchase agreement:** The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.

10. **Deferred payments:** The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

Trade Creditors/Accounts Receivables and Other Current Liabilities

1. **Cut off procedure:** The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the creditor accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately before the year-end and verify that the related invoices have been recorded as purchases of the current year.
2. **Reconciliation:** The auditor should check that the total of the creditors' balances agrees with the related control account, if any; the difference, if any, should be examined.
3. **Relevant document:** The auditor should examine the correspondence and other relevant documentary evidence to satisfy himself about the validity, accuracy and completeness of creditors/acceptances.
4. **Advance collection:** The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.
5. **Schedules:** While examining schedule of creditors and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:
   - Long outstanding items;
   - Unadjusted claims for short supplies, poor quality, discount, commission, etc.;
   - Liabilities not correlated/adjusted against related advances;
   - Authorization and correctness of transfers from one account to another. Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.
6. **Unusual payment:** In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.
7. **Liabilities outstanding:** The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.

Outstanding Expenses

The auditor should obtain a certificate from a responsible officer to the effect that all the outstanding expenses have been included in the current year's accounts. The amount paid on various accounts should be verified from the entries in the Cash Book. It should be ensured that the outstanding expenses includes that part which is unpaid at the date of the Balance Sheet. The following points should be noted:

1. He should carefully note that all expenses, e.g. rent, rates, interest, wages, salary, audit fee, legal expenses, etc., have been accounted for in the books.
2. He should check entries in the books passed on the basis of invoices to ensure that they are not related to the year under audit.
3. He should compare all the paid and unpaid expenses of the current year with those of the previous year to see that there is not much difference.
4. It should be ensured that all outstanding wages and salaries have subsequently been paid.

Loans unsecured

1. A loan is usually obtained on the basis of a loan' agreement. The auditor should refer to it to ascertain the condition on which the loan has been obtained for confirming that all the conditions as regards repayments of the loan, payment of interest thereon and provision of security have been duly complied with.
2. Further, where practicable, he should write to the party to confirm the balance of loan outstanding at the end of the year. A loan can be raised only by a competent authority - in the case of a company by the Board of Directors, in that of a partnership by the partners acting jointly and it that of proprietor concern by the proprietor himself.
3. In the case, of a company there may exist restrictions on the loans being raised in the Memorandum or Articles of Association. The right of the Board of Directors of a public company or private company which is subsidiary of the public company, under clause (d) of sub-section (1) of section 293 of the Companies Act to borrow money is restricted to the aggregate of the paid up capital of the company and its free reserves. However, the company in a general meeting can relax such a restriction by specifying the amount upto which amounts may be borrowed by the Board of Directors.
4. The deed of partnership in the case of a firm may also contain restrictions on the amount of loans that the partners can raise.
5. The auditor should therefore, examine the right of the borrowing authority to confirm that the loan or loans have been raised in the proper exercise of the authority vested in the Board of Directors or the partners as the case may be.
6. In view of the provisions contained in sub-section (IA) of section 227, it is necessary for an auditor to find out the purpose for which the loans have been raised; also confirm whether these have been utilized for the specified purpose or for some extraneous purposes.

Contingent Liabilities

- Accounting Standard 4 issued by the ICAI deals with the "Contingencies and Events occurring after the Balance Sheet Date". According to it "a contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence or non-occurrence, of one or more uncertain future events." The definition clearly envisages that either there may be contingent losses or contingent gains.

- As a matter of prudence, contingent gains need not be accounted for in financial statements since this may result in the recognition of revenue which may never be realised. Therefore, we have to consider contingent loss for which corresponding liability should be accounted for in financial statements.
- From the auditing point of view, different types of contingent liabilities are divided into two broad categories, one in respect of which a provision has been made and the other for which there is no provision. AS 4 provides guidance in respect of circumstances when provision has to be made for contingent losses.
- If disclosure of contingencies is required by following above considerations, then, the following information should be provided:
  (a) The nature of contingency;
  (b) The uncertainty which may affect the future outcome;
  (c) An estimate of the financial effect or a statement that such an estimate cannot be made;
- The Companies Act, 1956 requires disclosure of following liabilities by way of a note:
  1. Claims against the company not acknowledged as debts.
  2. Uncalled liability on shares partly paid.
  3. An ears of fixed cumulative dividend.
  4. Estimated amount of contracts remaining to be executed on capital account and not provided for.
  5. Other money for which the company is contingently liable.
  6. The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature of each such contingent liability, if material shall also be specified.
- The apprehended liabilities aforementioned usually are not easy to ascertain unless a comprehensive knowledge in regard to the working of the business is acquired from a study of the Minute of Book of Directors, files of correspondence with legal advisers and on collection of information from the officials of the company in regard to indisposed claims and legal actions pending against the company.

OBJECTIVE QUESTIONS

A. State with reasons whether following statements are true or false.

1. Verification means confirmation or proving the truth about the assets and liabilities appearing in the balance sheet.
2. Vouching is specially related to the assets and liabilities.
3. Valuation of assets means determine the correct value of the assets shown in the balance sheet.
4. Method which auditor follow should be vary from one year audit to another year of audit.
5. All cash balances in the same location should be verified simultaneously.

6. Physical verification of inventories is the responsibility of the auditor of the entity.
7. It is the responsibility of the auditor to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence.
8. Where the assets are numerous and difficult to verify, a verification will be done once in a three year.
9. Assets are the financial obligations of an enterprise other than owners' funds.
10. Future installments under hire purchase agreements for the purchase of assets may be shown as unsecured loans.

Ans: True: 1, 3, 5, 8.

False: 2, 4, 6, 7, 9, 10.

B. Match the following

Sr. No	Column A	Sr. No	Column B
a	Verification	i	Consistent
b	Method of valuation	ii	Stock Valuation
c	AS 2	iii	It is the act of checking title, possession and valuation of assets
d	Cash verification	iv	Expert valuation
e	Several assets purchased	v	Physical verification

Ans: a (iii), b (i), c (ii), d (v), e (iv)

Multiple Choice Questions

C. Select the most appropriate answer from the following:

1. _______________ means confirmation or proving the truth about the assets and liabilities appearing in the balance sheet.

   (a) Vouching
   (b) Verification
   (c) Confirmation
   (d) Inspection

2. ______________ is specially related to the assets and liabilities.

   (a) Vouching
   (b) Verification
   (c) Confirmation
   (d) Inspection.

3. ______________ of assets means determine the correct value of the assets shown in the balance sheet.
   (a) Vouching
   (b) Verification
   (c) Confirmation
   (d) Valuation
4. Method which auditor follow should be ___________ from one year audit to another year of audit.
   (a) Vary
   (b) Different
   (c) Consistent
   (d) None of the above.
5. Physical verification of inventories is the responsibility of the ____________ of the entity.
   (a) Employee
   (b) Auditor
   (c) Management
   (d) Any one
6. When inventory is under the custody and control of a third party, the auditor would________________________ for stock verification.
   (a) Take the confirmation from third parties.
   (b) Would not take confirmation.
   (c) Would take confirmation from the management.
   (d) All of the above.
7. Where the assets are numerous and difficult to verify, a verification will be done once in a__________ year.
   (a) Two
   (b) Five
   (c) Three
   (d) Four
8. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits,___________________________ , and provisions
   (a) Current assets
   (b) Installments payable under hire purchase agreements
   (c) Stock

(d) Debtors

9. In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent ______________________.

   (a) Of the market value of the security.
   (b) Whole value
   (c) Nil
   (d) Loan outstanding

10. Future installments under hire purchase agreements for the purchase of assets may be shown as __________________.

   (a) Unsecured loan
   (b) Secured loan
   (c) Debtors
   (d) Current liabilities.

11. The term '______________________' refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.

   (a) Provision
   (b) Contingent liabilities
   (c) Debtors
   (d) Current assets.

Ans: 1. (b), 2. (b), 3. (d), 4. (c), 5. (c), 6. (a), 7. (c), 8. (b), 9. (a), 10. (b), 11. (b)

ADDITIONAL OBJECTIVES

A. State with reasons whether following statements are true or false.

1. Verification involves obtaining and examining evidence in respect of an asset and liability.
2. The auditor is not at all concerned about the events after the date of the balance sheet.
3. If the stock is understated the profits and assets will be understated.
4. There is no need to verify cash at bank and the auditor can rely on the bank statements given by the company.
5. Patents should be written off over their legal period of validity or their working life, whichever is shorter.
6. No depreciation can be claimed in respect of free hold land.
7. Trademarks can only be self-generated.
8. Scrap method is one of the methods of valuation of assets.

9. The company can change the method of valuation as per its wish.
10. It is necessary for the auditor to scrutinize the ledgers of each asset and liability.

Ans: True: 1, 3, 5, 6, 8, 10.

False: 2, 4, 7, 9.

B. Match the following

Sr. No	Column A	Sr. No.	Column B
a	Method of valuation	i	Confirmation
b	Technique of verification	ii	Inspection
c	Debtors	iii	Avoids frauds
d	Advantage of verification	iv	Counting
e	Main purpose of verification	v	Avoids wrong accounting
		vi	Assets are owned, recorded, exist and disclosed.
		vii	Sale method
		viii	Replacement method

Ans: a (ii), b (ii), c (i), d (iii), e (vi).

C. Fill in the blanks with proper word.

1. Verification involves obtaining and examining evidence in respect of an item of _______ or ________.
2. The purpose of verification is to confirm the ownership, recording, existence and
3. ____________ procedures ensure separation of transactions of the current year from those of the next year.
4. Verification results in physical verification of assets. This helps in avoiding wherein assets are recorded but not actually available.
5. Mortgage means a ____________ on immovable property to secure a debt.
6. The auditor may observe the of assets being done by others.
7. The auditor should ensure if any even has happened after the date which has affected the value of the asset.
8. Trademarks can either be or purchased.
9. If the balance is a debtor's account is a credit balance, it indicates that _______________ are more than sales.
10. Debentures are to be shown under Non-Current liabilities under the head.

Ans: (1) Asset; Liability, (2) Disclosure, (3) Cut-off, (4) Frauds, (5) Charge, (6) Inspection, (7) Balance sheet, (8) Self Generated, (9) Receipts, (10) Long Term Borrowings.

D. Select the Correct answer

1. Verification of assets & liabilities is done to confirm the following:
   (a) Asset exists on the balance sheet date
   (b) Asset is legally owned by the company
   (c) Company has recorded all assets and liabilities
   (d) All of the above.
2. Which of the following is not a technique of verification:
   (a) Inspection
   (b) Observation
   (c) Counting
   (d) Confirmation
3. While verifying patents, the auditor has ensure that
   (a) Ownership of the patent is with the auditee
   (b) The patent is registered in the name of the auditee
   (c) The patent is valued properly in the balance sheet
   (d) All of the above
4. Closing stock with consignee is to be shown as the assets of
   (a) The consignor
   (b) The consignee
   (c) Both the above
   (d) Not to be shown as stock
5. Prior period Expenses are
   (a) Expenses of the current year paid in next year
   (b) Expenses of the previous year paid in current year
   (c) Expenses of the previous year paid in previous year
   (d) Expenses of the current year paid in previous year
6. While verifying bad debts, the auditor has to ensure that
   (a) The amount of bad debts has been properly authorized by concerned official
   (b) The debtor has written off the amount payable in his books
   (c) The debtor has turned insolvent
   (d) None of the above.
7. ____________ involves depositing the title deeds of the property with the lender as security.

(a) Equitable mortgage
(b) Pledge
(c) Hypothecation of goods
(d) Mortgage

8. An auditor is verifying valuation of investment in shares. Which is of the following document is not required by the auditor?

(a) Report from the accountant
(b) Valuation statement
(c) Original copy of the share certificate
(d) All of the above

9. Which of the following procedures need not be followed for verification of outstanding expenses?

(a) Prepare list of recurring expenses
(b) Verify payment of outstanding expenses
(c) Ledger Scrutiny
(d) Ensuring that the payment is made by cheque

10. Which of the following assets cannot be subject to physical verification?

(a) Debtors
(b) Machinery
(c) Loose tools
(d) Land

Ans: 1. (d), 2. (b), 3. (d), 4. (a), 5. (b), 6. (a), 7. (a), 8. (a), 9. (d), 10. (a)

Theory questions:

Explain the following:

(a) Explain the term verification.
(b) What are the techniques of verification
(c) Explain the difference between vouching and verification.
(d) What do you mean by valuation and explain the point to be consider while valuing the assets?
(e) How is stock verified?
(f) What are the points to be considered while valuing the stock?

3
CHAPTER

STANDARDS ON AUDITING

Introduction

Auditing is an examination of book of accounts with the help of documentary evidence and the explanation given. Hence, the Auditor must know what to examine, how to examine and to whom the report is to be submitted. In case of audit, the competent person collects the evidence, to whom the report is to be submitted. In case of audit, the competent person collects the evidence, evaluates the evidence, forms an opinion and communicates the opinion to the person interested. Therefore, the audit process involves three aspects as given below:

- Books of accounts
- Auditor
- Auditing process

What are Auditing Standards

The ICAI has issued the auditing which are called as Auditing and Assurance Standards. They were previously known as Standard Auditing Practices (SAP). SAs are the standards or norms or benchmarks against which the quality of audit work can be compared, measured and documented.

Need for Auditing Standards

Auditing standards play crucial role in:

1. Ensuring application of accepted financial reporting standards thereby lending credibility and wide acceptability.
2. Providing benchmarks against which the performance of the members can be measured and evaluated at global level also.
3. Ensuring compliance with the applicable legislative and regulatory framework.
4. Ensuring right approach of the professional in complex/emerging areas of audit.
5. Ensuring consistency and quality in the work performed by the professionals.

Objective of SA

Each SA contains an objective which provides the context in which the requirements are set of SAs. The auditors uses the objectives to judge whether sufficient appropriate audit evidence has been obtained in the context of the overall objective of audit. Where an individual objective has not been achieved, the auditors considers whether this prevents the auditor from achieving his overall objective.

SA 200 (Revised) Basic Principles Governing an Audit

Scope of This SA

1. This Standard on Auditing (SA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence & to be able to draw reasonable conclusions on which to base the auditor's opinion.
2. This SA is applicable to all the audit evidence obtained during the course of the audit. Other SAs deal with specific aspects of the audit, the audit evidence to be obtained in relation to a particular topic, specific procedures to obtain audit evidence and the evaluation of whether sufficient appropriate audit evidence has been obtained.

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

4. The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Selecting Items for Testing to Obtain Audit Evidence

5. When designing tests controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

Inconsistency in, or Doubts over Reliability of, Audit Evidence

6. If:
   (a) audit evidence obtained from one source is inconsistent with that obtained from another; or
   (b) The auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.

Audit Procedure for Obtaining Audit Evidence

7. As required by, and explained further in, SA 315 and SA 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

    (a) Risk assessment procedures; and

    (b) Further audit procedures, which comprise:

    (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and

    (ii) Substantive procedures, including tests of details and substantive analytical procedures.

Inspection

8. 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.

Observation

9. 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 an evidence about the performance of a process or procedure, but is limited to 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 Conformation

10. 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.

Analytical Procedures

11. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial. 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

12. Inquiry consists of seeking information of knowledgeable persons, financial, 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.

Relevance

13. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Reliability

14. 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 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.

Selecting All Items

15. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of test of controls; however, it is more common for test of details. 100% examination may be appropriate when, for example:

    (a) The population constitutes a small number of large value items;

    (b) There is a significant risk and other means do not provide sufficient appropriate audit evidence; or

    (c) The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

16. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

    (a) *High value or key items*. The auditor may decide to select specific items population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk prone or that have a history of error.

(b) *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.

(c) *Items to obtain information.* The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

Audit Sampling

17. Audit Sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

18. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal audit, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management.

Integrity Objectivity and Independence

19. The auditor should be straightforward honest and ‘sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

Confidentiality

20. The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

Skills and Competence

21. The audit should be performed and the report should be prepared with due professional care by persons who have adequate training, experience and competence in auditing.

22. The auditor requires specialised skills and competence which are acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination recognised for this purpose and practical experience under proper supervision. In addition, the auditor requires a continuing awareness of developments including pronouncements of ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

Work Performed by Others

23. When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by

others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956, the auditor's report should expressly state the fact of such reliance.

24. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

Documentation

25. The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

Planning

26. 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. Plans should be made to cover, among other things:

    (a) Acquiring knowledge of the client's accounting system, policies and internal control procedures;

    (b) Establishing the expected degree of reliance to be placed on internal control;

    (c) Determining and programming the nature, timing and extent of the audit procedures to be performed; and

    (d) Coordinating the work to be performed.

27. Plans should be further developed and revised as necessary during the course of the audit.

Audit Evidence

28. The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

29. Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

30. Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

    They are of two types:

    (a) Tests of details of transactions and balances;

    (b) Analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

Accounting System and Internal Control

31. Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

32. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

    Where the auditor concludes that he can rely on certain internal controls, his substantive procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing.

Audit Conclusions and Reporting

33. The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether:

    (a) The financial information has been prepared using acceptable accounting policies. which have been consistently applied;

    (b) The financial information complies with relevant regulations and statutory requirements;

    (c) There is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

    The audit report should contain a clear written expression of opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or statute or regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters dealt with in or as may be laid down or prescribed, under the relevant agreement or statute or regulation, as the case may be.

    When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons thereof.

SA 230 (AAS 3) DOCUMENTATION

Introduction

1. Standard on Auditing (SA) 200, "Basic Principles Governing an Audit" states, "The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles." The purpose of this Standard is to amplify the basic principle outlined above.

2. Documentation, refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.
3. Working papers:
   - Aid in the planning and performance of the audit;
   - Aid in the supervision and review of the audit work; and
   - Provide evidence of the audit work performed to support the auditor's opinion.

Form and Content

4. Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

   The form and content of working papers are affected by matters such as:
   - The nature of the engagement.
   - The form of the auditor's report.
   - The nature and complexity of the client's business.

- The nature and condition of the client's records and degree of reliance on internal controls.
- The needs in particular circumstances for direction, supervision and review of work performed by assistants.

5. Working papers should be designed and properly organised to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardisation of working papers (for example, checklists, specimen letters and standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality.
6. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of documentation is a matter of professional judgement since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.
7. All significant matters which require the exercise of judgement, together with the auditor's conclusion thereon, should be included in the working papers.
8. To improve audit efficiency, the auditor normally obtains and utilises schedules, analyses and other working papers prepared by the client. In such circumstances, the auditor should satisfy himself that these working papers have been properly prepared. Examples of such working papers are detailed analyses of important revenue accounts, receivables, etc.
9. In the case of recurring audits, some working paper files may be classified as permanent audit files, which are updated currently with information of continuing importance to succeeding audits, as distinct from current audit files, which contain information relating primarily to the audit of a single period.

A Permanent Audit File Normally Includes

- Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.
- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

The Current File Normally Includes

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.
- Evidence of the planning process of the audit and audit programme.
- Analysis of transactions and balances.
- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communications with other auditors, experts and other third parties.
- Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on and the related audit reports.

Ownership and Custody of Working Papers

10. Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client.

    The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

Effective Date

11. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after July 1, 1985.

STANDARD ON AUDITING (SA) 320 – AUDIT MATERIALITY

Introduction

The following is the text of the Auditing and Assurance Standard (AAS) 13, "Audit Materiality", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the 'Preface to the Statements on Standard Auditing Practices', issued by the Institute.

1. The purpose of this Standard is to establish standards on the concept of materiality and its relationship with audit risk.

Materiality

2. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

3. The objective of an audit of financial information prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is material is a matter of professional judgment.

4. The concept of materiality recognises that some matters. either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices. The auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transactions. Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which may have a significant bearing on the financial information, and considerations relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.

5. Although the auditor ordinarily establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.

6. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedure could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be.

7. Materiality should be considered by the auditor when:

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

   (b) Evaluating the effect of misstatements.

The Relationship between Materiality and Audit Risk

8. There is an inverse relationship between materiality and the degree of audit risk, that is, the higher the materiality level, the lower the audit risk and *vice versa*. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low, but- the risk that it could be misstated by an extremely small amount might be very high. The auditor takes the 'inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:

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

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

Materiality and Audit Risk in Evaluating Audit Evidence

9. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from that at the time of evaluating the results of his audit procedures. This could be because of a change in circumstances or a change in the auditor's knowledge as a result of the audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change.

10. In forming his opinion on the financial information, the auditor should consider whether the effect of aggregate uncorrected misstatements on the financial information is material. Qualitative considerations also influence an auditor in reaching a conclusion as to whether the misstatements are material.

11. The aggregate of uncorrected misstatements comprises:

    (a) Specific misstatements identified by the auditor, including the net effect of uncorrected misstatements identified during the audit of previous periods; and

    (b) The auditor's best estimate of other misstatements which cannot be specifically identified (that is, projected errors).

12. When the auditor tests an account balance or class of transactions by an analytical procedure, he ordinarily would not specifically identify misstatements but would only obtain an indication of whether misstatements might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that misstatements might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him to estimate the aggregate misstatement in the balance or class.

13. When an auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known misstatements identified by him in his sample to the items in the balance or class from which his sample was selected. That projected misstatement, along with the results of other substantive tests. contributes to the auditor's assessment of aggregate misstatement in the balance or class.

14. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, or if auditor determines that the aggregate of uncorrected misstatements causes the financial information to be materially misstated. he should consider requesting the management to adjust the financial information or extending his audit procedures. The adjustment of financial information may involve, for example, application of appropriate accounting principles, other adjustments in amounts or the addition of appropriate disclosure of inadequately disclosed matters. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate.

Effective Date

15. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1996.

STANDARD ON AUDITING (SA) 570 – GOING CONCERN

Introduction

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.
3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.
4. An entity's continuance as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of information to the contrary.

Appropriateness of the Going Concern Assumption

5. The auditor should consider the risk that the going concern assumption may no longer be appropriate.
6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.
7. Financial Indications
   - "Negative net worth or negative working capital.
   - "Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
   - Adverse key financial ratios.
   - Substantial operating losses.
   - Substantial negative cash flows from operations.
   - Arrears or discontinuance of dividends.
   - Inability to pay creditors on due dates.
   - Difficulty in complying with the terms of loan agreements.
   - Change from credit to cash-on-delivery transactions with suppliers.
   - Inability to obtain financing for essential new product development or other essential investments.
   - Entering into a scheme of arrangement with creditors for reduction of liability. Operating Indications
   - Loss of key management without replacement.
   - Loss of a major market, franchise, licence or principal supplier.
   - Labour difficulties or shortages of important supplies.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal proceedings against the entity that may, if successful, result in judgments that could not be met.
- Changes in legislation or government policy.
- Sickness of the entity under any statutory definition.

8. The significance of such indications can often be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, obtaining additional capital or having funding arrangements backed by government. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Audit Evidence

9. When a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve, to the auditor's satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future.

10. During the course of the audit, the auditor carries out audit procedures designed to obtain audit evidence as the basis for the expression of an opinion on the financial statements. When a question arises regarding the going concern assumption, certain of these procedures may take on additional significance or it may be necessary to perform additional procedures or to update information obtained earlier. Procedures that are relevant in this connection may include:

    - Analyse and discuss cash flow, profit and other relevant forecasts with management.
    - Review events after the balance sheet date for items affecting the entity's ability to continue as a going concern.
    - Analyse and discuss the entity's latest available interim financial statements.
    - Review the terms of debentures and loan agreements and determine whether any have been breached.
    - Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
    - Review the status of matters under litigation and claims.
    - Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
    - Consider the entity's position concerning unfilled customer orders.

Audit Conclusions and Reporting

11. After the procedures considered necessary have been carried out, all the information required has been obtained, and the effect of any plans of management and other mitigating factors have been considered, the auditor would decide whether the question raised regarding the going concern assumption has been satisfactorily resolved.

Going Concern Assumption Considered Appropriate

12. If, in the auditor's judgement, sufficient appropriate audit evidence has been obtained to support the going concern assumption, the auditor would not qualify his report on this account.

13. If, in the auditor's judgement, the going concern assumption is appropriate because of mitigating factors, in particular management plans for future action, the auditor should consider whether such plans or other factors need to be disclosed in the financial statements. Where the auditor concludes that such plans or other factors need to be disclosed, but have not been adequately disclosed, the auditor should express a qualified or adverse opinion, as appropriate.

Going Concern Question not Resolved

14. If, in the auditor's judgement, the going concern question is not satisfactorily resolved, the auditor would consider whether the financial statements:

    (a) Adequately describe the principal conditions that raise substantial doubt about the entity's ability to continue in operation for the foreseeable future;

    (b) State that there is significant uncertainty that the entity will be able to continue as going concern and, therefore, may be unable to realise its assets and discharge its liabilities in the normal course of business; and

    (c) State that the financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts. or to amounts and classification of liabilities that may be necessary if the entity is unable to continue as a going concern.

    (d) Provided the disclosure is considered adequate, the auditor would not express a qualified or adverse opinion.

15. If adequate disclosure is made in the financial statements, the auditor should ordinarily express an unqualified opinion. However, he should, in his report, add a paragraph that highlights the going concern problem by drawing attention to the note in the financial statements. The following is an example of such a paragraph:

    'We draw attention to Note X in the financial statements. The Company incurred a net loss of XXX during the year ended March 31, 19X1 and, as of that date, the Company's current liabilities exceeded its current assets by XXX and its total liabilities exceeded its total assets by XXX. These factors, along with other matters as set forth in Note X, raise substantial doubt that the Company will be able to continue as a going concern."

The auditor is not precluded from expressing a disclaimer of opinion for a going concern uncertainty.

16. If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate. The following is an example of the explanation and opinion paragraphs when a qualified opinion is to be expressed:

    "The Company has been unable to renegotiate its borrowings from its bankers. Without such financial support there is substantial doubt that it will be able to continue as a going concern. Consequently, adjustments may be required to the recorded asset amounts and classification of liabilities. The financial statements (and notes thereto) do not disclose this fact.

    In our opinion, subject to the omission of the information dealt with in the preceding paragraph, the financial statements give a true and fair view of the financial position of the Company at March 31, 19X1 and the results of its operations for the year then ended."

Going Concern Assumption Considered Inappropriate

17. If, on the basis of the additional procedures carried out and the information obtained, including the effect of mitigating circumstances, the auditor's judgment is that the entity will not be able to continue in operation for the foreseeable future, the auditor would conclude that the going concern assumption used in the preparation of the financial statements is inappropriate. If the result of the inappropriate assumption used in the preparation of the financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

18. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1999.

SA 200A: OBJECTIVE AND AUDIT OF FINANCIAL STATEMENTS

Introduction

This Standard describes the overall and scope of the audit of general purpose financial statements of an enterprise by an independent auditor. Accounting to ICAI the term 'General Purpose Financial Statement" includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for the use of members/ shareholders, creditors, employees and public at large.

Objective of an Audit

The objective of an audit of financial statement, prepared within a framework of recognized accounting policies and practices and relevant statutory requirement, if any, is to enable an audit to express an opinion on such financial statements. The auditor's opinion helps in determination of the true and fair view of the financial position and opinion is an assurance as to future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

Responsibility for the Financial Statements

While the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for their preparation is that of the management of enterprise. Management's responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies and the safeguarding of the assets of the enterprise. The audit of the financial statements does not relieve management of its responsibilities.

Objective and Scope of the Audit of Financial Statements

As per SA, the scope of audit of financial statements is determined by the auditor having regard to the following:

(a) Terms of engagements

(b) Requirement of relevant law

(c) Pronouncement of ICAI

- The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:

(a) Making a study and evaluation of accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures; and

(b) Carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

- The Auditor Determines Whether the relevant information is properly disclosed in the financial statements by:

(a) Comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarise the transactions and events recorded therein: and

(b) Considering the judgments that management has made in preparing the financial statements; accordingly, the auditor assesses the selection and consistent application of accounting policies, the manner in which the information has been classified and the adequacy of disclosure.

- The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. Because of these factor, absolute certainty in auditing is rarely attainable.
- In forming his opinion on the financial statemans, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognizes that because of

the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement by management may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result a material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions.

- The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements. It is a matter in which a decision is arrived at on the basis of the auditor's professional experience and judgement.
- The auditor is not expected to perform duties which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.
- Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statements should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed, as appropriate.

Effective Date

This Standard on Auditing because operative for all audits relating to accounting periods beginning on or after April, 1 1985.

SA 500: AUDIT EVIDENCE

- Auditor is required to obtain sufficient appropriate audit evidence to enable them to draw reasonable conclusions on which they can base their opinion on financial information.
- Auditor normally relies on evidence that is persuasive rather than conclusive in nature. Auditor may obtain evidence on a selective basis by way either jugmental or statistical sampling procedures. Evidences is obtained through performance of compliance and substantive procedures.
- Compliance procedures are tests designed to obtain reasonable assurance that internal controls on which audit reliance is placed are in effect. Substantive procedures are designed to obtain evidence as to completeness, accuracy and validity of data produced by accounting system.
- Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of assertions of existence, effectiveness and continuity. Obtaining audit evidence from substantive procedures is intended to reasonably assure the auditor

of assertions of existence, right and obligations, occurrence, completeness, valuation, measurement, presentations and disclosure.

- To test the reliability, few generalizations are useful such as external evidences is more reliable than internal evidence, written evidence is more reliable then oral evidence and self obtained evidence is more reliable than obtained through the entity.
- Auditor gains increased assurance when audit evidence obtained from different sources is consistent. Various methods for obtaining audit evidence includes inspection, observation, inquiry and confirmation, computation and analytical review.
- Emphasis is to be laid on considering relevance and reliability of audit evidence obtained during the course of audit, and focus is to be laid on designing and performing audit procedures to obtain relevant and reliable audit evidence.

OBJECTIVE QUESTIONS

1. State whether following statements are true or false

1. SA deals with audit accounts.
2. Books of accounts are prepared by the Auditor.
3. Auditor are members of the Institute of Company Secretaries of India.
4. In India SAs are issued by ICSI.
5. Preface to stand on quality control is issued by ICWAI.
6. ICWAI is the founder members of IFAC.
7. IAASB contribute to global harmonization of the standards.
8. SAs are issued in new structure.
9. SRE are applied in review of historical financial information.
10. SQC stands for Standards on Quality Control.
11. SA 200 deals with quality control.
12. SQC 1 sets out the responsibilities of the audit firm.
13. Professional judgement is essential for conduct of audit.
14. SQC sets responsibility of the audit firm for establishment of policies and report.
15. Professional judgement is not essential for conduct of audit.
16. Audit evidence is necessary to support the auditor’s opinion and report.
17. The SAs do not override laws and regulations that govern an audit.
18. Audit programme is working papers.
19. Permanent file is a part of working papers.

20. Audit planning facilitates timely completion of work.
21. Communication with the previous auditor is an activity of initial engagement.
22. Knowledge of client's business is not a must for audit planning.
23. The auditor need not decide materiality.
24. The auditor need not develop audit plan.
25. Establishment of audit strategy for small entity is complex.
26. With smaller audit team coordination becomes difficult.
27. Audit programme proves assessment of control risk.
28. Reviewing the general records is the first step in initial audit engagement.
29. Materiality can be judged from contractual violation.
30. The Auditor should revise the materiality level as the audit progresses.
31. Materiality should be reviewed as audit progresses.
32. SA 200 A deals with scope of audit.
33. Disclosure requirement can be verified by performing evaluation of accounting policies.
34. The auditor need not take into account effect of inherent limitations.
35. Physical condition of certain assets can be determined by an auditor.
36. Discovery of material misstatement is not the objective of audit.
37. Audit risk includes inherent risk.
38. The audit need not exercise professional judgement at planning stage.
39. Preliminary assessment of control risk is done by the auditor by test control.
40. The auditor should express quality opinion when high detection risk is determined.
41. Enquiry is the means of collection of evidence
42. Appropriateness of audit evidence refers to quality and reliability
43. Audit evidence can come in different forms. The least persuasive evidence is documents third parties mailed to the auditor
44. The most reliable evidence is confirmation of an account payable balance
45. Physical inventory must be conducted at the end of the year
46. Analytical procedures means evaluation of financial information through analysis of financial and non-financial data.
47. Sales to capacity utilization is a financial and non-financial relations
48. SA 570 deals with Going Concern

49. Loss of major market is an operating indicator of appropriateness of going concern

50. SA 700 deals with Auditor's report

Ans: **True:** 1, 2, 3, 7, 8, 9, 10, 12, 13, 14, 16, 17, 18, 19, 20, 21, 28, 29, 30, 31, 32, 33, 34, 36, 37, 39, 40, 41, 42, 43, 44, 46, 47, 48, 49, 50

False: 4, 5, 6, 11, 15, 22, 23, 24, 25, 26, 27, 35, 38, 45]

1. B. Match the following:

	Group A		Group B
a	Books of A/cs	i	ICAI
b	Auditors are	ii	Benchmarks
c	SAs issued by	iii	Founder member of IFAC
d	SAs are	iv	Council of ICFAI
e	ICAI	v	Chartered Accountants
		vi	Prepared by the entity

Ans: a (vi), b (v), c (i), d (ii), e (iii)

	Group A		Group B
a	SRE	i	Standards on related services
b	SRS	ii	SA 200
c	SQC	iii	Depends on applicable financial reporting
d	Independent Auditor	iv	Schedule VI
e	Form of Opinion	v	Standards on Quality Control
		vi	Standards on Assurance Engagement

Ans: a (vi), b (i), c (v), d (ii), e (iii)

	Group A		Group B
a	Professional judgement	i	Is the risk that auditor expressed an inappropriate audit opinion
b	Audit risk	ii	Permanent file
c	Working Paper	iii	Working paper
d	Letter confirmation	iv	Permanent paper
e	Study and evaluation of internal control	v	Essential for conduct of audit

Ans: a (v), b (i), c (ii), d (iii), e (iv)

	Group A		Group B
a	Audit planning	i	Planning activity
b	Preparation of Audit programme	ii	Facilitates coordination of work
c	Materiality in planning	iii	SA 320
d	Materiality is judged from	iv	Surrounding circumstances
e	Scope of Audit	v	SA 200 A
		vi	SA 200

Ans: a (ii), b (i), c (iii), d (iv), e (v)

C. Fill in the gaps

1. Books of accounts are prepared as per ………………..
2. Auditors in India are ………………. ………………..
3. In India ………….. issues Standards of Audit.
4. AAS previously known as …………..
5. Exposure drafts to SAs are issued by ……………..
6. SA is issued under the authority of the ………… of ICAI.
7. Preface to the standard of quality control is issued by ………..
8. ICAI is the founder member of……………..
9. ………… contributes to global harmonization.
10. ………… are standards on related services
11. SA………..deals with conduct of audit.
12. SQC………… sets the responsibilities of the auditor.
13. ……………… judgment is essential for conduct of audit.
14. ………….. is the measure of the quantity of audit evidence.
15. ………….. ………… is the component of total audit risk.
16. Concept of materiality is applied in …………and………….audit.
17. SAs do not override…………and………….
18. Documentation refers to the…………….. ……………….
19. Permanent Audit files include…………………..
20. Working papers include………..and………
21. Audit programme is an example of ……………… ………………
22. ……… ………… facilitates coordination of work.
23. Preparation of audit programme is a …………….activity.

24. Establishment of audit strategy for small entity is less…………………
25. The auditor requires assistance of specialists in………… work.
26. The first step in initial audit engagement is……………….
27. Materiality can be judged from……………..
28. SA 320 requires the auditor to revise …………………. ……………..
29. …………. ……………… is the risk that the auditor gives an inappropriate audit opinion.
30. Scope of audit of financial statements is determined with regard to …………….
31. Disclosure requirement can be verified by ……… ……………….. ………………….
32. The auditor should take into account ………… ………….. of audit.
33. Physical conditions of certain assets can be decided by ………… ……………….
34. ……………. of engagement cannot restrict the scope of an audit.
35. Audit risk includes …………….. ……………….. ………………
36. At planning stage, the auditor should use ……………… …………………..
37. Audit risk is caused by nature of ………………….. ………………..
38. Audit evidence is ………………
39. ………………….. refers to declaration made by the management.
40. Audit process is a process of ……………….
41. Reliability of audit evidence is dependent on ………………. of evidence.
42. Competence of evidence is true when evidence is …………… and ………….
43. It is the…………….responsibility to physically ………… inventory.
44. If the inventory is ……………… the auditor should attend physical count of inventory.
45. Physical inventory count may be conducted at a date other than the ……… …………
46. ………… working capital is a financial indication.
47. Review of …………… cases is a source of audit evidence.
48. Plan to………….. assets raises the doubt about going concern.
49. If going concern assumption about auditor's judgment is appropriate, the auditor should issue……….report.
50. The auditor must ……………. the report if management's explanation is inadequate.
51. Auditor's responsibility is to express an ………………. about financial statement.
52. The auditor expresses ………. opinion when the auditor is unable to obtain sufficient evidence.

53. The auditor shall ………… an opinion when circumstances involve multiple uncertainties.

54. ………………… is responsible for preparation of consolidated financial statements.

Ans: (1) GAAP, (2) CA, (3) ICAI, (4) SAP, (5) AASB, (6) Council, (7) ICAI, (8) IFAC, (9) IAASB, (10) SREs, (11) 200, (12) 01, (13) Professional, (14) Sufficiency, (15) Inherent risk, (16) Planning, (17) Laws, regulations, (18) Working papers, (19), M/A, (20) Memorandum of Association, (21) Audit planning, (22), Planning, (23) Planning, (24) Complex, (25) Technical, (26) Review of general records, (27) Size, (28) Materiality level, (29) Audit risk, (30) Term of engagement, (31) Financial Statement Analysis, (32) Inherent limitations, (33) Technical experts, (34) Terms, (35) Risk of expression of bad opinion, (36) Professional judgment, (37) Audit evidence, (38) Documents, (39) Assertion, (40) Persuation, (41) Source, (42) Valuable, reliable, (43) Management, (44) Material, (45) Period end, (46) Negative, (47) Legal, (48) Liquidate, (49) Unqualified, (50) Qualify, (51) Opinion, (52) Qualified, (53) Disclaim, (54) Management.

D. Multiple Choice Questions Select the correct alternatives

1. Auditors in India are members of
   (a) ICAI (b) ICWAI
   (c) ICSI (d) IMC
2. Auditing process involves
   (a) Books of accounts (b) Auditor
   (c) Process (d) All of the above
3. In India SAs are issued by
   (a) ICWAI (b) ICSI
   (c) ICAI (d) IMC
4. AAS previously known as
   (a) Guidance notes (b) SAP
   (c) GAAP (d) None of the above
5. Exposure drafts of SA is finalized by
   (a) AASB (b) IASB
   (c) ICAI (d) ICWAI
6. It is the duty of the auditor to see that audit is conducted as per
   (a) SAs (b) Company law
   (c) Income tax law (d) SEBI Rules
7. Preface to the standard of Quality Control is issued by
   (a) ICSI (b) IIM
   (c) ICAI (d) ICWAI

8. ICAI is the founder member of
   (a) IFAC (b) IASB
   (c) IIMS (d) CIMA
9. SAA now have new structure
   (a) Introduction (b) Objective
   (c) Definition, Requirements, Application (d) All of the above
10. Standards on review of historical financial information are known as
    (a) SRE (b) SAE
    (c) SRS (d) SQC
11. The standards prescribes the responsibilities of Auditor
    (a) SA 200 (b) SA 400
    (c) SA 501 (d) SA 240
12. The auditor has to follow ethical requirement as required by
    (a) SA 440 (b) SA 200
    (c) SA 340 (d) SA 330
13. Responsibility of the audit firm to establish policies and procedures is laid down by
    (a) SQC 1 (b) SA 207
    (c) SA 240 (d) SA 440
14. Professional judgment needs to be exercised
    (a) At the beginning of the audit (b) At the end of the audit
    (c) During the conduct of audit (d) Through the audit
15. Total audit risk has
    (a) Inherent risk (b) Control risk
    (c) Detection risk (d) All of the above
16. Inherent limitations of an audit arise from
    (a) Nature of financial reporting (b) Nature of audit procedures
    (c) A and B (d) None of the above
17. Concept of materiality is applied by the auditor in
    (a) Planning audit (b) Performing audit
    (c) A and B (d) None of the above
18. In case laws and regulations differ from SAs
    (a) Audit is conducted as per SAs (b) Audit is conducted as per laws
    (c) Audit is conducted as per regulations (d) All of the above

19. Documentation refers to
    (a) Working papers
    (b) Memorandum
    (c) Letter of confirmation
    (d) All of the above
20. Working papers state
    (a) Client's name
    (b) Type of engagement
    (c) Nature of client business
    (d) All of the above
21. Working paper files may be classified as
    (a) Permanent file and current file
    (b) Permanent file and temporary
    (c) Office file and household file
    (d) None of the above
22. Audit planning facilitates
    (a) Timely completion of work
    (b) Identification of potential problem
    (c) Utilization of assistants properly
    (d) All of the above
23. In the case of first audit the auditor should follow the activities
    (a) Communicating with the previous auditor
    (b) Acquiring knowledge of client's business
    (c) Specific audit documents
    (d) All of the above
24. The audit should document
    (a) Overall audit strategy
    (b) Audit programme
    (c) Client's business
    (d) A and B
25. Audit programme prove
    (a) Sufficient evidence was obtained
    (b) Work was adequately planned
    (c) Compliance with GAAP
    (d) Assessment of control risk
26. In audit planning
    (a) An engagement should not accepted after fiscal year
    (b) An inventory count must be observed on the balance sheet data
    (c) The client's audit committee should not be told of the specific audit procedures
    (d) It is a practice to carry out substantial part audit on interim dates
27. Procedures are primarily designed to
    (a) Detect fraud that result in misstated financial statements
    (b) Assess control work
    (c) Gather corroborative evidence
    (d) Obtain information for information disclosures

28. The first step of initial audit engagement is
    (a) Preparation of rough draft of financial statement
    (b) Assessment of control records
    (c) Reviewing the general records
    (d) Consulting with the previous audit
29. Materiality can be judged from
    (a) Nature of item (b) Legality
    (c) Contractual violation (d) All of the above
30. The audit should determine performance materiality for
    (a) Assessing the risk of material misstatement
    (b) Assessing the risk of immaterial misstatement
    (c) Determining extent of further audit procedures
    (d) All of the above
31. The audit should document
    (a) Materiality for financial systems
    (b) Performance materiality
    (c) Accounting balance
    (d) All of the above
32. Scope of audit determined with regard to
    (a) Terms of engagement (b) Relevant legislation
    (c) Pronouncements of ICAI (d) All of the above
33. The items which influence decisions of users of financial statement are
    (a) Material items (b) Immaterial items
    (c) Significant items (d) None of the above
34. Discovery of material misstatement is
    (a) The objective of audit (b) Not the objective of audit
    (c) The only objective of audit (d) None of the above
35. Audit Risk means
    (a) The risk that auditor give an inappropriate opinion when financial statements are mis-stated
    (b) The risk of giving wrong audit report
    (c) The accounts have material errors
    (d) All of the above

36. Audit Risk includes
    (a) Inherent risk (b) Control risk
    (c) Detection risk (d) All of the above
37. Detection risk cannot be accurately assessed at
    (a) Planning stage (b) During audit
    (c) At the end of audit (d) None of the above
38. Assessment of inherent risk at planning stage depends on
    (a) Integrity of management (b) Experience of management
    (c) Natural of business (d) All of the above
39. Assertion by the management about financial statements are
    (a) Existence (b) Occurrence
    (c) Completeness (d) All of the above
40. Audit evidence may be classified
    (a) On the sources of evidence (b) On the means of collection
    (c) On the type of evidence (d) A and B only
41. SA 500 required the auditors as regards audit evidence
    (a) Sufficiency appropriate
    (b) Information to be used as audit evidence
    (c) Selecting item for testing to obtain evidence
    (d) All of the above
42. Sufficiency of evidence refers to
    (a) Quantum of evidence (b) Quality of evidence
    (c) Reliability of evidence (d) None of the above
43. Order of reliability of audit evidence is
    (a) External, external internal, internal external and internal evidence
    (b) Internal, external
    (c) Internal, external and internal
    (d) None of the above
44. Management assertions depend on
    (a) Existence of evidence (b) Completeness of evidence
    (c) Presentation (d) Valuation
45. To be competent, evidence must be both
    (a) Timely and substantial (b) Reliability and documents
    (c) Valid and relevant (d) Useful and objective

46. The auditor should obtain a written representation concerning
    (a) Completeness and documents
    (b) Assurance regarding adherence to procedures
    (c) A and B
    (d) None of the above
47. Segment information means the information to be disclosed in respect of
    (a) Reportable segment (b) Regional segment
    (c) Revenue segment (d) Earning segment
48. While obtaining evidence regarding litigation against a client, the CA would be least interested in determining
    (a) An estimate of when the matter will be resolved
    (b) The period in which the cause of the litigation occurred
    (c) The probability of an unfavorable outcome
    (d) An estimate of the potential loss
49. The ratios used in analytical procedures include
    (a) G.P. Ratio (b) Debtor turnover
    (c) Stock turnover (d) All of the above
50. The audit should consider appropriateness of going concern as per
    (a) SA 510 (b) SA 570
    (c) SA 530 (d) SA 210
51. Indicators of doubt about going concern include
    (a) Financial indications (b) Operating indications
    (c) Other indications (d) All of the above
52. Cash losses is a
    (a) Financial indication (b) Operating indication
    (c) Other indication (d) All of the above
53. When inappropriateness of the going concern arises the author should gather evidence by
    (a) Analysis of budgeted by
    (b) Analysis of interim financial statements
    (c) Review of legal cases
    (d) All of the above

54. If the doubt about going concern assumption is dispelled by the management, the auditor may issue
    - (a) Unqualified report
    - (b) Qualified report
    - (c) Clean
    - (d) Foul report
55. If going corner assumption is in appropriate, the author should give
    - (a) Adverse opinion
    - (b) Clean report
    - (c) Qualified report
    - (d) None of the above
56. SA 700 has the objective of forming opinion about
    - (a) Audit Report
    - (b) Statutory Report
    - (c) Financial Report
    - (d) None of the above
57. Audit Report should contain
    - (a) Auditor's Responsibility
    - (b) Auditor's opinion
    - (c) Signature of the auditor
    - (d) All of the above
58. Management is responsible for
    - (a) Preparation of financial statements
    - (b) Audit of accounts
    - (c) Issue of audit certificate
    - (d) None of the above
59. Audit Report format is prescribed by
    - (a) Company law
    - (b) Standards on Audit
    - (c) Income tax law
    - (d) None of the above

Ans: 1 (a), 2 (d), 3 (c), 4 (b), 5 (a), 6 (a), 7 (c), 8 (a), 9 (d), 10 (a), 11 (a), 12 (b), 13 (a), 14 (a), 15 (a), 16 (c), 17 (c), 18 (d), 19 (d), 20 (d), 21 (a), 22 (d), 23 (d), 24 (d), 25 (b), 26 (d), 27 (c), 28 (c), 29 (d), 30 (d), 31 (d), 32 (d), 33 (a), 34 (b), 35 (d), 36 (d), 37 (a), 38 (d), 39 (d), 40 (d), 41 (d), 42 (a), 43 (a), 44 (a), 45 (b), 46 (c), 47 (a), 48 (a), 49 (d), 50 (b), 51 (d), 52 (a), 53 (d), 54 (a) 55 (a), 56 (a), 57 (d), 58 (a), 59 (a).

Theory Questions:

1. What are the responsibilities as per SA 200?
2. What are the provisions of SA 200A?
3. What are the objectives of audit documentation?
4. What are the contents of permanent file and current file?
5. How does the auditor develop audit plan?
6. What are the provisions of SA 320?

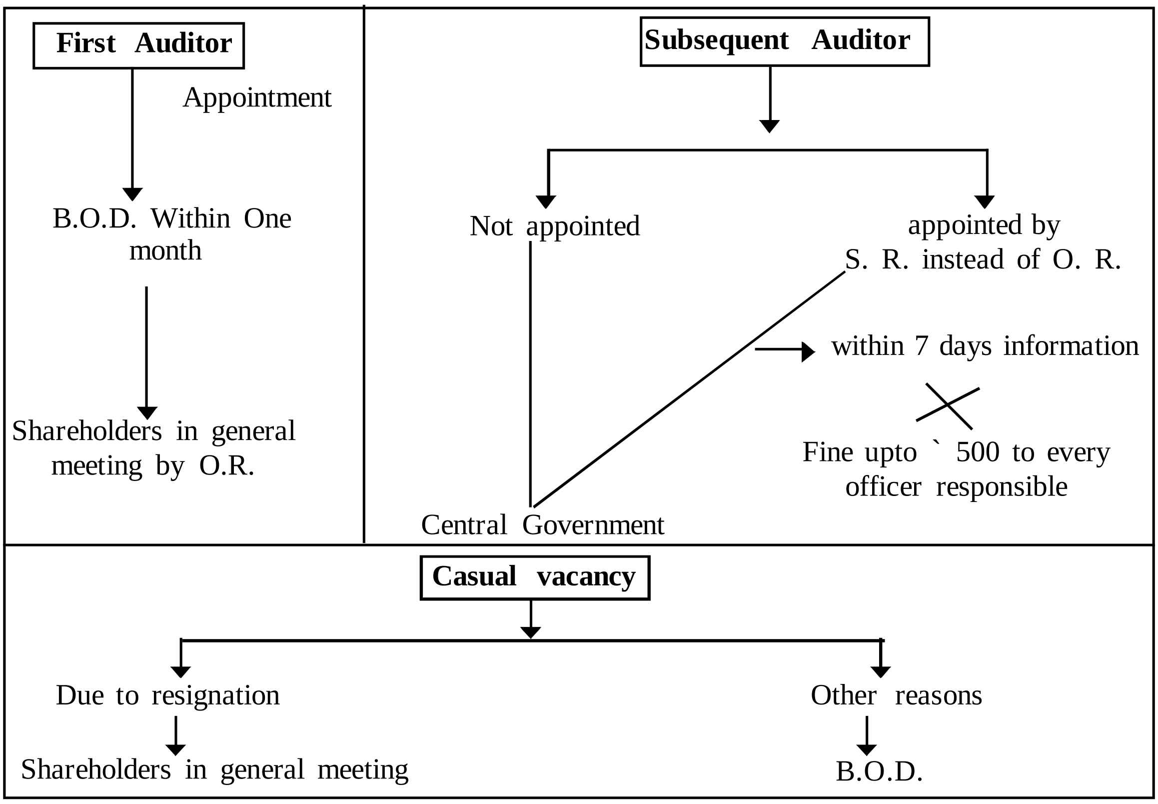
4 CHAPTER

AUDIT OF LIMITED COMPANIES

INTRODUCTION – APPOINTMENT OF AUDITORS

According to Section 224 of the Companies Act, 1956, it is compulsory for every company to get its accounts audited. Sub-Section (1) Section 224 lays down that every company shall, at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting till the conclusion of next annual general meeting. The provisions of Section 224 are as under:

Appointment of Auditors



1. Appointment of First Auditor: Section 224 (5)

The provisions relating to first auditors are as follows:

ANTR

1. Appointment – Manner of Appointment

The first auditors of a company shall be appointed by the Board of directors within 1 month of the date of registration of the company, if the Board fails to appoint the first auditors within the said period of 1 month; the company in general meeting may appoint the first auditors by passing an ordinary resolution.

2. No Notice of Appointment

There is no requirement regarding intimation of appointment to the first auditors by the company. Similarly, first auditors are not required to inform the registrar whether they have accepted the appointment or not.

3. Tenure of Office

The first auditors shall hold office until the conclusion of the first annual general meeting of the company.

4. Removal (Before first AGM)

The company may remove the first auditor by passing an ordinary resolution at a general meeting. No special notice is required for such removal. However, procedure prescribed under Section 225(2) and (3) shall be followed. Any other person may be appointed in his place of whose nomination a notice has been given to the members of the company not less than 14 days before the date of the meeting.

2. Appointment by Shareholders in Annual General Meeting: Section 224 (1)

The provisions relating to subsequent auditors can be explained as follows:

ANTR

1. Appointment at an AGM

At every annual general meeting, the auditors are appointed or reappointed by the company by passing an ordinary resolution. The appointment of auditors at an annual general meeting is an item of ordinary business.

2. Notice of Appointment

After appointing the auditors, the company shall intimate the auditors of such appointment within 7 days of the appointment [Section 224(1)]. The auditor in turn shall give notice to the registrar in Form. No. 23B within 30 days as to whether. he has accepted or refused the appointment [Section 224(1 A)]. Notice to registrar shall be given in respect of every appointment or reappointment. As such, where an auditor is reappointed, notice to the registrar is required.

3. Tenure of Office

The auditors hold office from the conclusion of the meeting in which they are appointed to the conclusion of the next annual general meeting [Section 224(1)]. As such, the appointment of auditors is made in terms of this period and not for any financial year.

4. Removal Before Expiry of Term (before an AGM)

The company may, after obtaining the previous approval of the Central Government, remove the auditors before the expiry of their term by passing an ordinary resolution [Section 224(7)]. No special notice is required for such removal. However, procedure prescribed under Section 225(2) and (3) shall be followed.

3. Compulsory Re-appointment of Retiring Auditor: Section 224(2)

Auditor Holds office from conclusion of the annual general meeting in which he is appointed till the conclusion of next annual general meeting. Generally retiring auditor is reappointed in the next AGM (not automatically).

According, to Section 225(1), a special notice is required for a resolution at an Annual General Meeting appointing as an auditor a person other than a retiring auditor. A special notice is also required for a resolution providing expressly that a retiring auditor shall not be reappointed.

On receipt of such a special notice, the company shall forthwith send its copy to the retiring auditor.

The retiring auditor, on receipt of a copy of such special notice, may make representations in writing to the company. Such representations should not exceed a reasonable length. He may also request the company to circulate his representations to the members of the company. The company must circulate such representations to the members unless the representations are received by the company too late. A notice of the resolution should be given to the members: stating also the fact of representations having been made. If a copy of the representation *is* not sent to the shareholders either because they were received too later or because of the default of the company, the auditor may required that the representation shall be read out at the meeting. This will be without prejudice to his right to be heard orally. If the Company Law Board on application either of the *company* or of *any person claiming to be aggrieved, is satisfied that this right has been abused to secured needless publicity* {or defamatory purposed, copies of representations need not be sent out or read our at the meeting}. These provision shall also apply to the removal of first auditors appointed by the Board of Directors.

When a new auditor is appointed in place of the retiring auditor, the company within seven days of the meeting should intimate to the new auditor about his appontment, who in turn should inform the Registrar within one month of the receipt of the intimation in writing that he has accepted or refused to accept appointment. The new auditor should also communicate in writing to the retiring auditor before accepting the audit. If an auditor accept a position as an auditor previously held by another Chartered Accountant, without first communicating with him in writing it amounts to breach of professional etiquette or ethics. Failure to do so constitute a misconduct leading to an enquiry into his conduct by the council of the Institute and, if proved it may result in the person declared unfit to continue to be a member of the Institute.

The objective of communicating with the previous auditor is that the member (the auditor) may have an opportunity to know the reasons for change, in order to be able to safeguard his own interest, the legitimate interest of the public and the independence of existing auditors.

4. Appointment by Central Government 224 (3) and (4)

The provisions relating to appointment of auditors by the Central Government are explained as under:

AND

1. Appointment by Central Government

On receipt of notice from the Company, the Central Government may appoint a person to fill the vacancy.

2. Notice to the Central Government

Where at an annual general meeting, no auditors are appointed or reappointed; the company shall, within 7 days give notice of that fact to the Central Government. The, notice shall be given to the Regional director to whom the powers have been delegated by the Central Government.

3. Default

If a company fails to give notice to the Central Government, the company and every officer the company who is in default shall be punishable with fine which may extend to ` 5,000.

5. Appointment by Special Resolution-Section 224 A:

The provisions in this regard are explained as follows:

1. When is Special Resolution Required for Appointment of Auditor?

CAN GIFT

The appointment or reappointment of an auditor shall be made by a special resolution if not less than 25% of the subscribed share capital, whether singly or in any combination is held, by

Central Government;

(i) Any State Government;

(ii) Nationalised bank;

(iii) Government Company;

(iv) Insurance company carrying on general insurance business;

(v) Any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51 % of the subscribed share capital;

(vi) The Public Financial Institution

2. Consequences of Failure to Pass the Special Resolution

Where a company to which this section applies omits or fails to pass a special resolution shall be deemed that no auditor or auditors had been appointed by the company an thereupon the company shall, within 7 days, give notice of that fact to the Central Government and the Central Government may appoint a person to fill the vacancy.

3. Example

The subscribed capital of PQR Ltd is ` 10,00,000 consisting of 1,00,000 shares of ` 10 each. Its shareholding pattern as on the date of AGM is as follows:

(i) IDBI (a Public Financial Institution) holds 15,000 shares:

(ii) Union Bank of India (a Nationalised Bank) holds 6,000 shares.

(iii) Hindustan Machine Tools (a Government Company) holds 3,000 shares.

(iv) General Insurance Corporation of India holds 1,000 shares.

In this case, since 25% of subscribed, share capital is held by the specified government instrumentalities, the appointment of the auditor shall be made by passing a special resolution at the annual general meeting.

6. Appointment in Casual Vacancy: Section 224 (6)

The provisions of section 262 are explained as follows:

TOM

1. Tenure of Office of New Auditor

Any auditor appointed in a casual vacancy shall hold office until the conclusion of the next annual general meeting.

2. Other Joint Auditors May Act

Till the time a casual vacancy continues, the remaining auditor or auditors (i.e., the other joint auditors), if any, may act.

3. Manner of Filling Casual Vacancy

The Board may fill any casual vacancy in the office of an auditor. However, where a casual vacancy is caused by the resignation of an auditor, the vacancy shall be filled by the shareholders in general meeting.

Meaning of Casual Vacancy

The term ‘casual vacancy’ has not been, defined by the Companies Act. It implies a vacancy caused by the auditor ceasing to act as such after accepting a valid appointment, e.g. – due to death, disqualification, resignation etc.

It must be carefully noted that a vacancy arising out of a resignation of an auditor falls within the meaning of ‘casual vacancy’ as explained above. However, such a casual vacancy can be filled only by the shareholders in general meeting.

7. Appointment of Auditors in Government Companies: Section 619

A government company has been defined in Section 617 “as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any state Government or jointly by them and includes a company which is a subsidiary of a Government Company.”

In respect of any Government company appointment or re-appointment shall be done by Controller and Auditor General of India.

Qualification of An Auditor: Section 226

Qualifications and Disqualifications of Auditors (section 226)

Qualification

- Practising C.A, Individual
- Partnership firm in which all partners are Practising C.A. Appointment must be in firm’s name
- Holders of part B Certificate

Disqualification

→ Cannot be body corparate, since liability is limited

→  ✕ Officer or employee of the company

→  ✕ Partner or officer of employee of the company.

→  ✕ Indebted to the company or given guarantee of any third party to the company for an amount exceeding ` 1,000

→  ✕ Hold voting rights.

→ subsidiary ✕ holding

Holding ✕ subsidiary

→ 224 (1B) limits Prescribed number of audits (ceiling limit)

Section 226 seeks to ensure that an auditor is professionally qualified, independent and does not have any financial interest in the company. He should maintain integrity and give his unbiased and objective Judgement.

Disqualification of Company Auditors: Section 226 (3)

Qualifications

As per section 226 (1) and (2), following persons shall be eligible to act as an auditor of a company:

(i) A chartered accountant within the meaning of the Chartered Accountants Act, 1949, may be appointed as an auditor. As per the Chartered Accountants Act. 1949, or only chartered accountant holding a certificate of practice can be appointed as an auditor.

(ii) A firm where all the partners practicing in India are qualified for appointment may be appointed by its firm name to be the auditor of a company. In such a case any partner may act as an auditor in the name of the firm.

(iii) A holder of certificate in Part B State entitling him to act as an auditor of companies may be appointed as an auditor.

Disqualifications

As per section 226 (3) and (4) none of the following persons shall be qualified for appointment

VIP SEA

(i) A person who by virtue of any of the aforesaid provisions is disqualified for appointment as an auditor of any other body corporate which is that company's subsidiary, i.e., holding company, or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(ii) A person who is indebted to the company for an amount exceeding ` 1,000 or who has given any guarantee of any third person to the company for an amount exceeding: ` 1,000.

(iii) A person who is partner, or who is in the employment, as an officer or employee of the company.

(iv) A person holding any security of the company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000, i.e., 13.12.2000. The expression 'security' means any instrument which carries voting rights.

(v) An officer or employee of the company.

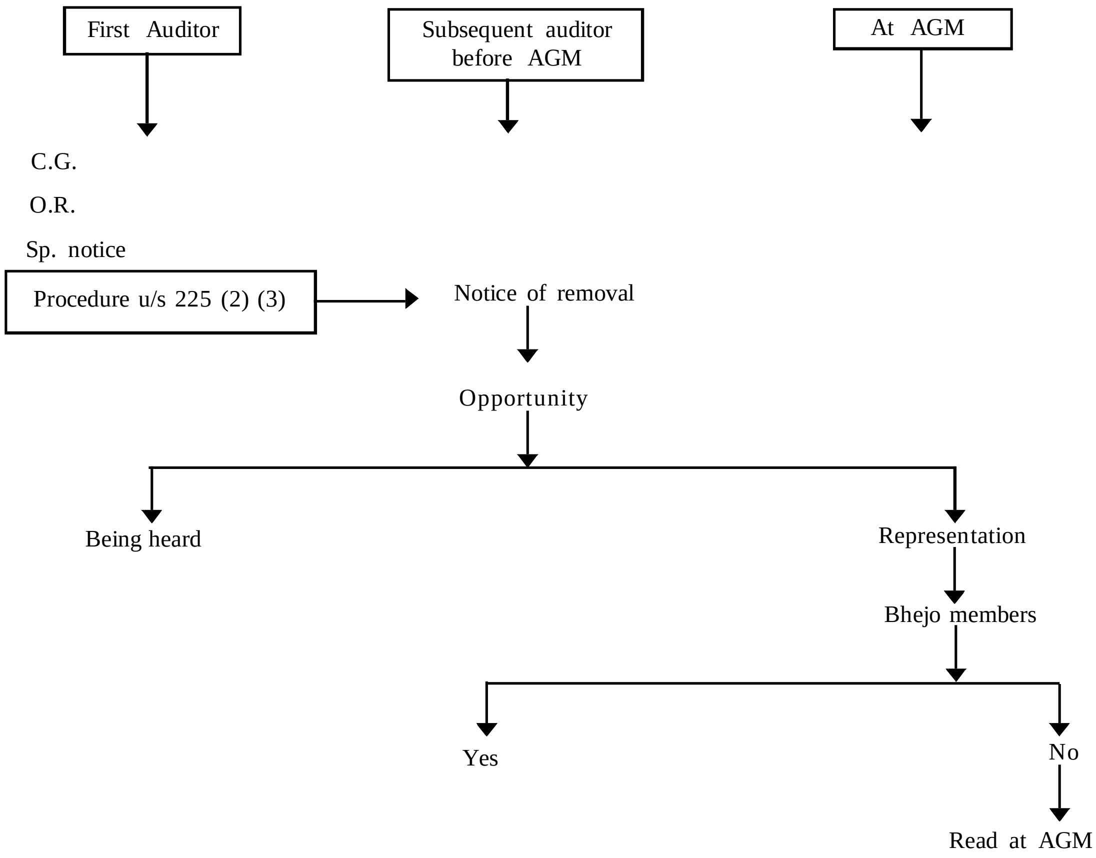
(vi) A body corporate

Removal of An Auditor: Section 224 (7) And Section 225

The removal of an auditor can be discussed under the following heads:

1. Removal before the expiry of the term – Section 224 (7):

Removel of Auditiors (Sections 224, 225 and 408))



The provisions relating to removal of auditors are explained as follows:

SP DR

1. Safeguards Against Unjustified Removal

Unscrupulous Company's management may remove the auditors only because the auditors refused to comply with their unreasonable requests Thus, to protect the independence of auditors, enough safeguards have been inserted in the Act for removal of auditors.

2. Procedure Prescribed under section 225 (2) and (3)

PC RND

(i) Position where Representation is not sent by the Company: If a copy of the representation is not sent as aforesaid because the representation was received too late or because of the company's default, the auditor may require that the representation, shall be read out at the meeting.

(ii) Company Law Board Intervention: The copies of the representation need not be sent out; and the representation need not be read out at the meeting if the Company Law Board is satisfied that this right is being abused by the auditor to secure needless publicity for defamatory matter. The Company Law Board may order the company's costs on such an application to be paid by the auditor, notwithstanding that he is not third party to the application. The application to the Company Law Board may be made either by the company or by any other person who claims to be aggrieved.

Where a company has two joint auditors and at an annual general meeting the company intends to reappoint only one of them, it would amount to a change in the office of auditors, i.e., removal of auditors at an annual general meeting. Therefore, it would require a special notice and compliance with section 225(2) and (3).

(iii) Rights of the Auditor: The auditor has the following rights:

- Right to be heard orally at the meeting.
- Right to make a representation in writing to the company (not exceeding a reasonable length)
- Right to get his representation circulated amongst the members.

(iv) Notice to Auditor: The notice for removal of an auditor shall be sent forthwith by the company to the auditor.

(v) Duty of the Company: Where a request is made by the auditor to circulate the representation, it shall be the duty of the company

- to send a copy of the representation to every member of the company; and
- to state the fact of the representation having been made in the notice given to the members.

3. Different Cases of Removal

CASE I

Removal of auditors can be studied under the following heads:

(i) Removal by the Central Government: Where, in order to prevent oppression or mismanagement, the Central Government appoints nominee directors or additional directors in the company, it may issue such directions to the company, as it may consider necessary. Such directions may include a direction to remove the existing auditor and to appoint another auditor. On such a direction being given, the removal of the auditor shall be deemed to have come into effect as if all the provisions of the Act in this behalf have been complied with, without requiring any further act or thing to be done (Section 408).

(ii) Removal at an AGM: The company may, at an annual general meeting, provide expressly that a retiring auditor shall not be reappointed or appoint an auditor other than a retiring auditor. Special notice shall be required for any of the above two purposes. Special notice ensures that no existing auditor is removed without the matter being specifically considered by the shareholders. The procedure prescribed under section 225(2) and (3) shall be followed for his removal

(iii) Removal of Subsequent Auditors Before Expiry of their Term Before an AGM: The company may, after obtaining the previous approval of the Central Government, remove the auditors before the expiry of their term by passing an ordinary resolution. No special notice is required for such removal, However, procedure prescribed under section 225(2) and (3) shall be followed.

The requirement of obtaining the approval of the Central Government ensures that no existing auditor is removed from his office without sufficient reasons.

(iv) Ensure Removal of First Auditors (Before the first AGM): The company may remove the first auditor by passing an ordinary resolution at a general meeting. No special notice required for such removal. However, procedure prescribed under section 225(2) and (3) shall be followed.

Any other person may be appointed in his place of whose nomination and notice has been given to the members of the company not less than 14 days before the date of the meeting

4. Reason for Removal of an Auditor

Removal of an auditor may become necessary in a case where he is unable to fulfill his duties for any reason or becomes unsuitable for continuing in his office. As such, where an auditor is negligent in the performance of his duties, he can be removed from the office.

Remedy where the Auditor Refuses to Audit: Where the auditor inordinately delays or refuses to audit and refuses to resign, the only course open to the company is to have the auditor removed. The auditor may also be held liable for ‘professional and other misconduct’.

2. Appointing a New Auditor in Place of Retiring Auditor (After Expiry of Term) – Section 225

Section 225 of the Companies Act, 1956, lays down the following procedure for the appointment of a new auditor in place of a retiring auditor or if a resolution is to be passed not to appoint retiring auditor as the auditor. The procedure is to prevent unfair and unjust removal of auditor:

(1) **Special notice:** A special notice of intention to remove,such resolution (to appoint new or not to appoint old) must be given to the company by shareholders (holding 10% voting rights), at least 14 days before the annual general meeting.

(2) **Notice to be sent to retiring auditor:** On receipt of such a notice, the company must send a copy thereof to the retiring auditor.

(3) **Right to make a representation:** The retiring auditor has a right to make a written representation (not exceeding a reasonable length) to the company. He may also ask the company to notify such a representation to the shareholder of the company.

(4) **Duty of the company:** Where the auditor has made a representation to the company and requested it's notification to the shareholders, it is the duty of the company to send it to the shareholders unless such a representation has been received too late by the company.

(5) **Representation not notified:** If a copy of the representation is not sent to the shareholders either because it was received too late to be thus sent or because of a default of the company, the auditor may insist that the representation shall be read out at the meeting.

(6) **Auditor should not to abuse his right:** If an application by the company or any other aggrieved person, the court is satisfied that rights conferred upon the auditor by Section 225 are being abused to secure needless publicity or defamatory publicity, it may order that representation need not be sent out to the shareholders or read out at the meeting.

(7) **Right to attend meeting:** The auditor who is to be removed has the right to attend the General meeting where his removal is to be discussed. He has also a right to speak at such meeting.

(8) **New Auditor to Communicate with the Retiring Auditor:** As a matter of professional conduct, the new auditor should communicate with the retiring auditor in writing before accepting appointment. If he fails to do so, he may be held liable to disciplinary action as per regulations of the Institute of Chartered Accountants of India.

(9) **Provision applicable in every case:** The provisions of Section 225 are applicable in every case of removal of auditor before the expiry of his term.

Remuneration of An Auditor: Section 224 8

Provisions of Remuneration

The remuneration of auditors is fixed by the authority appointing them. This can be explained as under:

B – SC_2

1. Where Appointed by the Board of Directors

When an auditor is appointed by the Board of Directors, remuneration is also fixed by them; the resolution appointing the auditor should also prescribe the remuneration. Sometimes, the resolution may empower the chairman or the Managing Director of the company to fix the remuneration of the auditor.

2. Where Appointed by Shareholders

In this case the remuneration is determined by the shareholders at the AGM. Sometimes, the shareholders may delegate the power of fixing remunerations to the Board of Directors or the Chairman, the Managing Director, etc.

Where a retiring auditor is reappointed and if the resolution does not refix his remuneration~ the auditor would get the same remuneration as he was previously getting.

3. If Appointed by the Central Government

In this case the remuneration is fixed by the Central Government.

The remuneration shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

Remuneration Other than Audit Fees

Where an auditor is called upon to render service other than those as an auditor, he is entitled to get extra remuneration for such services, e.g. representing for tax matters, etc. Such remuneration may be fixed by mutual agreement between the auditor and the management.

Disclosure of Remuneration in Final Accounts

The Profit and Loss Account shall contain or give by way of a note, a detailed information in regard to the amount paid to the auditor, whether as fees, expenses or otherwise for services rendered.

(i) As auditor

(ii) As advisor or in any capacity in respect of:

- Taxation matters;
- Company Law Matters;

OBJECTIVE QUESTIONS

A. State with reasons whether following statements are true or false.

1. A firm of a chartered Accountants cannot be appointed as a statutory auditor.
2. A body corporate can be appointed as a statutory auditor.
3. Partner or officer or employee of the company is not qualified for appointment of statutory auditor.
4. Casual vacancy arising on account of resignation can be filled in by Board of Directors.
5. The Directors can fill in a casual vacancy of an Auditor
6. The auditor who is intended to be removed has no right to attend Annual General Meeting in which his removal is to be discussed.
7. If the Auditor is not satisfied with the records he can call for the explanation on any accounting matters.
8. The auditor need not be chartered accountant.
9. A firm of Chartered Accountants can be appointed as auditors.
10. The Central Government has no power to suspend certified auditor.
11. A body corporate can be appointed as auditors.
12. Chartered accountants are not allowed to form a limited company.
13. Chartered accountants can form partnership firms.
14. A director is not qualified to be appointed as an auditor.
15. An officer can be appointed as an auditor.
16. Independence of a statutory auditor is necessary for audit companies.
17. A person who is a debtor of company for an amount exceeding ` 1000 is disqualified for appointment.
18. First auditor can be appointed by the board of directors.
19. Casual vacancy arising on account of verification cannot be filled by the board.
20. Subsequent auditors can be appointed by the shareholders.
21. The Central Government can appoint an auditor.
22. Appointment of the auditor of a Government company is made by the Controller & Auditor General of India.
23. Shareholders have to pass special resolution for appointment of an auditor.
24. The retiring auditor can be reappointed.
25. The first auditor can be removed by the shareholders in the general meeting.
26. Central Government approval is not necessary for removal of an auditor.
27. The tenure of office of the auditor is from one AGM to next AGM.
28. The company is punishable in case of any default.

29. Auditor has no lien on working papers.
30. Auditor has right to take legal and technical advice.
31. Auditor has to sign Audit Report.
32. Auditor is liable for negligence.
33. Auditor is liable for misstatement in the prospectus.

Ans: True: 1, 2, 4, 5, 6, 9, 12, 13, 14, 16, 17, 18, 19, 20, 21, 22, 24, 25, 27, 28, 31, 32, 33

False: 3, 7, 8, 10, 11, 15, 23, 26, 29]

B. (A) Match the following

	Group A		Group B
a	Statutory auditor	i	Disqualification of auditor
b	A body corporate	ii	Board of Directors
c	First Auditor	iii	Annual General Meeting
d	Subsequent Auditor	iv	Caused by resignation
e	Casual vacancy	v	Shareholders in the general meeting
f	Removal of Auditor	vi	14 days notice
		vii	Chartered Accountant

Ans: a (vii), b (i), c (ii), d (iii), e (iv), f (v)

(B) Match the following

	Group A		Group B
a	Chartered Accountant	i	Board of directors
b	Corporate body	ii	Due to resignation
c	Appointment of first auditor	iii	Can remove auditors
d	Casual vacancy	iv	Disqualified as auditor
e	General meeting	v	Qualification of auditor

Ans: a (v), b (iv), c (i), d (ii), e (iii)

(C) Match the following

	Group A		Group B
a	Audit report	i	To receive remuneration
b	Right	ii	Submitted to shareholders
c	Audit report	iii	Shareholders
d	Removal of subsequent auditor	iv	Fixed by shareholders
e	Remuneration	v	Submitted to shareholders.

Ans: a (v), b (i), c (ii), d (iii), e (iv)

C. Fill in the blanks with proper word

1. Section ________ the Act lays down the qualifications and disqualification of a company auditor.
2. A person to be appointed as a statutory auditor should be qualified ________.
3. Appointment of subsequent auditor to be made by the shareholders at every ________.
4. Auditor appointed under casual vacancy shall hold the office till the conclusion of next ________.
5. For the removal of the Auditor an approval of the ________ government has to be obtained.
6. The audit working papers are the property of ________.
7. The audit report should be signed by ________.
8. The holder of certificate under ________ 1956 can be appointed as an auditor of a company.
9. ________ auditor is appointed within one month of registration.
10. _______________ can appoint first auditors.
11. First auditor can hold office till the ________ of the 1st general meeting.
12. Every company has to appoint an auditor at every ________ meeting.
13. ___________ vacancy arises due to resignation of the auditor.
14. Retiring auditor can make ________ representation.
15. Audit fees should be disclosed in _____________ A/c.

Ans: (1) 226, (2) Chartered Accountant, (3) AGM, (4) AGM, (5) Central, (6) The Auditor, (7) The Auditor, (8) Companies Act, (9) First, (10) B.O.D, (11) Conclusion, (12) AGM, (13) Casual, (14) Written, (15) P & L A/c.

Multiple Choice questions

D. Select the most appropriate answer from the following:

1. Company's auditor may be appointed by

   (a) Board of Directors (b) Managing director

   (c) Managers (d) Employees

2. First auditor of a newly formed company can be appointed by the Board of Directors within __________.

   (a) Two months (b) One month

   (c) Three month (d) One week

3. Appointment of subsequent auditor to be made by the shareholders at every.
   (a) Annual general meeting (b) Extraordinary general meeting,
   (c) Board meeting (d) Creditors meetings
4. Failure to appoint Auditor at Annual General meeting should be communicated within 7 days of AGM
   (a) Central government (b) State government,
   (c) Local government (d) Board directors
5. The audit working papers are the property of
   (a) Board directors (b) Shareholders
   (c) Auditor (d) CEO
6. As per company law an auditor is disqualified for appointment in
   (a) Less than 20 companies (b) More than 20 companies
   (c) Less than 10 companies (d) More than 15 companies
7. The auditor has to inform the register about his acceptance within
   (a) 30 days (b) 10 days,
   (c) 21 days (d) 20 days
8. Failure of the company to inform the central government the penalty is
   (a) ` 500 (b) ` 50,
   (c) ` 5000 (d) ` 1,000
9. The vacancy caused by death of the auditor can be filled in by
   (a) BOD (b) Old auditor
   (c) Central Govt., (d) State Govt
10. CAG stands for
    (a) Controller & Auditor General (b) Control Audit General
    (c) Control of AGM (d) None of the above
11. First duty of the auditor is to
    (a) Verify (b) Investigate,
    (c) To detect fraud, (d) None of the above
12. The person to act as a watchdog is
    (a) Auditor (b) Accountant,
    (c) Shareholder (d) None of the above

13. Branch auditor can be
    (a) Shareholder (b) Board of Director
    (c) Auditor u/s 224 (d) Any one
14. The auditor must be a
    (a) Director (b) CA,
    (c) ICWAI, (d) ICS
15. The first auditor is appointed by
    (a) Bankers (b) Shareholders,
    (c) Board of directors (d) None of the above
16. Removal of auditor can be done by
    (a) Accountant (b) Shareholders,
    (c) Director (d) BOD
17. The right of the auditor is to
    (a) Access books of accounts (b) Attend general meeting,
    (c) A & B (d) None
18. The persons responsible for appointment of statutory auditor are
    (a) Directors (b) Shareholders,
    (c) Govt. of Maharashtra (d) None of the above
19. The authority to remove the first auditor before expiry of the term is with
    (a) Shareholders (b) Board of directors
    (c) Central Govt. (d) None of the above
20. The auditor has a right to
    (a) obtain information & explanation
    (b) obtain information from employees
    (c) obtain information & explanation from employees and officers of the company
    (d) None of the above
21. Statutory auditor can be
    (a) A chartered accountant (b) A firm of chartered Accountants,
    (c) A company of chartered accountants (d) A & B
22. First auditor is appointed under section.
    (a) 224 (5) (b) 228
    (c) 331 (d) 435

Ans: 1 (a), 2 (b), 3 (a), 4 (a), 5 (c), 6 (b), 7 (a), 8 (a), 9 (a), 10 (a), 11 (a), 12 (a), 13 (c), 14 (b), 15 (c), 16 (b), 17 (c), 18 (b), 19 (a), 20 (c), 21 (d), 22 (a)

ADDITIONAL OBJECTIVES

A. State with reasons whether following statements are true or false.

1. Auditors is an expert in Accounts.
2. Audit Report must be factual.
3. Audit Report should be biased.
4. There is no difference in Audit Report and Audit Certificate.
5. As 28 provides for audit report.
6. Audit Report is qualified when important books are maintained.
7. Audit Report need not be qualified even if wrong method of depreciation is followed.
8. A company limited by shares has to hold a Statutory Meeting.
9. The Auditor has to express his opinion about the books of accounts.

Ans: **True:** 1, 2, 5, 8, 9

False: 3, 4, 6, 7

Theory Questions:

Explain the following:

(a) Statutory auditor.

(b) Qualifications of an auditor.

(c) Disqualifications of an auditor.

(d) Appointment of first auditor of a limited Co.

(e) Appointment of auditor by Central Government.

(f) Appointment of auditor in casual vacancy.

(g) Appointment of auditor by special resolution.

(h) Reappointment of a retiring auditor of a Co.

(i) Removal of auditor of a Co.