

PAPER – 2 : AUDITING AND ASSURANCE

QUESTIONS

1. Statements issued by the Institute of Chartered Accountants of India are mandatory in nature while guidance notes are recommendatory in nature. Comment.
2. What are Auditing and Assurance Standards? What is the procedure for issuing Auditing and Assurance Standards?
3. Detection of errors and frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account. Comment.
4. The auditor may encounter circumstances that individually or in combination, indicate the possibility that the financial statements may contain a material misstatements resulting from fraud or error. List some circumstances that indicate a possible misstatement.
5. Discuss the relationship between
 - (a) Auditing and accounting
 - (b) Auditing and Law
 - (c) Auditing and Statistics & Mathematics
 - (d) Auditing and Financial Management
6. Write a note on AAS 1 " Basic Principles Governing an Audit".
7.
 - (a) Define Internal auditing.
 - (b) What are the objectives of internal audit?
 - (c) State the areas in which internal audit operates.
8.
 - (a) What do you mean by management representation letter?
 - (b) During the course of audit, CA Tripathi , the auditor seeks a representation letter from ABC Ltd. confirming that the company has a satisfactory title to all assets and there are no encumbrances on the company's asset. Management of ABC Ltd. refuses to give the representation letter in this regard. What is the option available for the auditor as per AAS 11.
 - (c) Give example of a management representation letter as regard to accounting policies, assets, capital commitment and investments.
9.
 - (a) What do you mean by analytical procedures?
 - (b) State at which stages of audit analytical procedures can be used?
10. How will you vouch and/or verify the following:
 - (a) Machinery acquired under Hire-purchase system

- (b) Borrowing from Banks
 - (c) Sale Proceeds of Junk Materials
 - (d) Discounted bills receivable dishonoured
11. Write a note on "Independence of Auditor".
12. Gupta & associates, a firm of chartered accountants has been appointed as an auditor of ABC Ltd. situated in Delhi. Kumar associates, a firm of other chartered accountants has been appointed for auditing a division of the same company situated at Nagpur. What procedures should Gupta & associates follow while using the work of Kumar Associates with respect to the financial information of Nagpur division included in the financial information of ABC Ltd.
13. (a) Why knowledge of business is important to the auditor?
(b) From where the auditor can obtain knowledge of the industry and the business entity?
14. (a) What do you mean by related party ?
(b) What audit procedures should be followed by auditor to identify the related parties?
15. Write short notes on the following:
(a) Buy Back of Own Securities.
(b) Option on Share Capital
16. Part I, Schedule VI to the Companies Act, 1956, prescribes the form of balance sheet and the requirements relating thereto. What is the specific requirement as per Part I, Schedule VI to the companies Act, 1956 relating to
(a) Share Capital
(b) Contingent Liabilities
(c) Investments
(d) Secured Loans
17. At the AGM of XYZ Ltd., Mr Y was appointed as the statutory auditor. He, however, resigned after 3 months due to personal reason. State, how the new auditor will be appointed by XYZ Ltd.
18. What do you mean by audit matters of governance interest? Prepare a list of such matters those may be included in audit matters of governance interest.
19. (a) What do you understand by Computer Information Systems ?
(b) The overall objective and scope of an audit change in a CIS environment. Comment.
(c) Enumerate documentation requirement under computer information system.

20. Write short notes on :
- (a) Operational Audit
 - (b) Reliability of Audit Evidence
 - (c) Audit Programme
 - (d) Cut-off Transactions relating to Inventories

SUGGESTED ANSWERS/HINTS

1. The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:
- (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and
 - (b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom.
- 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.
2. Auditing and Assurance Standards are Auditing Standards, which prescribe the way the auditing should be conducted. Auditing and Assurance Standards are the benchmarks by which the quality of audit performance can be measured and achievement of objective can be documented. AASs have been issued "with a view to

securing compliance by members on matters which in the opinion of the Council of the Institute are critical for the proper discharge of their functions”

AASs are therefore , Mandatory from the dates specified either in the respective AAS or by notification issued in this behalf by the Council of ICAI.

Procedure for Issuing the Statements on Standard Auditing Practices : Broadly, the following procedure is adopted for the formulation of Auditing and Assurance Standards.

- (i) The Auditing and Assurance Standards Board (AASB) determines the broad areas in which the Auditing and Assurance Standards (AASs) need to be formulated and the priority in regard to the selection therefor.
 - (ii) In the preparation of AASs, the AASB is assisted by study groups constituted to consider specific subjects. In the formation of study groups, provision is made for participation of a cross-section of members of the Institute.
 - (iii) On the basis of the work of the study groups, an exposure draft of the proposed AAS is prepared by the Board and issued for comments by members of the Institute.
 - (iv) After taking into consideration the comments received, the draft of the proposed AAS is finalised by the AASB and submitted to the Council of the Institute.
 - (v) The Council of the Institute will consider the final draft of the proposed AAS, and if necessary, modify the same in consultation with the AASB. The AAS is issued under the authority of the Council.
3. The purpose of an independent financial audit is to determine whether the financial statements reflect a true and fair view of actual financial position and working results of an enterprise. Thus section 227 of the Companies Act, 1956, requires the auditor of a company to state whether in his opinion, the accounts give a true and fair view of its state of the company's affairs as at the end of its financial year, and of the profit or loss for its financial year. Thus the auditor's objective in a company audit is to conduct an independent examination of the financial statements and express an opinion about their reliability in representing the company's financial position and working results.

The AAS-2 “Objective and Scope of the Audit of Financial Statements” states that the objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. Further it clarifies that “the auditor's opinion helps determination of the true and fair view of the financial position and operating results of the enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of an enterprise or the efficiency or effectiveness with which the management has conducted the affairs of the enterprise”.

As AAS 4, The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements, recognizes, an audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatements, whether caused by fraud or error. Accordingly, the auditor plans and performs an audit with an attitude of professional skepticism so as to be able to identify and properly evaluate factors that increase the risk of a material misstatement in financial statements resulting from fraud or error. The standard requires that when the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated. The standard, however, recognizes that an auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. An audit does not guarantee that all material misstatements will be detected because of such factors as the use of judgement, the use of testing, the inherent limitations of internal control, and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only a reasonable assurance that material misstatements in the financial statements will be detected.

It can thus be seen that the objective of independent financial audit is the determination of truth and fairness of financial statement representations.

However, you should not infer that the detection of errors and frauds is no longer an audit objective. It is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries cannot be considered as a true and fair statement. To establish whether the financial statements show a true and fair state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors and frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account.

On a consideration of what has been discussed, it may be summed up that auditing has the principal objective of seeing whether or not the financial statement portray a true and fair state of affair and of reporting accordingly. An incidental and secondary, but by no means an insignificant audit objective, flowing from the former, is detection of errors and frauds and making recommendations to prevent their occurrence.

4. During the course of the audit, the auditor may encounter circumstances that indicate that the financial statements may contain a material misstatement resulting from fraud or error. Examples of such circumstances that, individually or in combination, may make the auditor suspect that such a misstatement exists are given in AAS 4 "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements". The circumstances listed below are only examples; neither all of these circumstances are

likely to be present in all audits nor is the list necessarily complete.

- ◆ Unrealistic time deadlines for audit completion imposed by management.
 - ◆ Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
 - ◆ Limitation in audit scope imposed by management.
 - ◆ Identification of important matters not previously disclosed by management.
 - ◆ Significant difficult-to-audit figures in the accounts.
 - ◆ Aggressive application of accounting principles.
 - ◆ Conflicting or unsatisfactory evidence provided by management or employees.
 - ◆ Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
 - ◆ Information provided unwillingly or after unreasonable delay.
 - ◆ Seriously incomplete or inadequate accounting records.
 - ◆ Unsupported transactions.
 - ◆ Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year-end.
 - ◆ Transactions not recorded in accordance with management's general or specific authorization.
 - ◆ Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.
 - ◆ Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
 - ◆ Significant differences from expectations disclosed by analytical procedures.
 - ◆ Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
 - ◆ Evidence of an unduly lavish lifestyle by officers or employees.
 - ◆ Unreconciled suspense accounts.
 - ◆ Long outstanding account receivable balances.
5. (a) Auditing and Accounting: Both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of

the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements.

- (b) **Auditing and Law** : The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.
 - (c) **Auditing and Statistics & Mathematics** : With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.
 - (d) **Auditing and Financial Management** : With the overgrowing field of auditing, the financial services sectors occupies a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place. The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.
6. **AAS 1 "Basic Principles Governing an Audit"** : This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1985.

AAS 1 describes the basic principles which govern the auditor's professional responsibilities. These basic principles should be complied with whenever an audit is carried out.

Definition of Audit as per AAS 1 : As per AAS 1 an audit is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. The term "financial information" covers financial statements.

Following are the basic principles governing an audit as per AAS 1 :

- (1) Integrity, Objectivity and Independence: 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.

The principle of integrity refers that the auditor should be honest and sincere in his professional work. For instance monies belonging to client, if entrusted to an auditor, should be kept in a separate bank account and used only for the purpose for which they are intended.

The principles of objectivity and independence depicts that the auditor's opinion should not be influenced by personal prejudice or bias. Independence refers that while expressing his opinion , the auditor should not influenced by other's directions. The auditor should be independent of entity under audit both in fact and in appearance. Thus, he should not only be independent in reality, but the others must also not doubt his independence. For instance an auditor should not have financial interest in entity under audit. Further an auditor should not be an employee or a director of the entity under audit. The principle of ethical conduct have been detailed both by the Chartered Accountants Act, 1949 and the Companies Act, 1956.

- (2) Confidentiality : 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 . Exceptions to this are (a) an auditor may disclose information acquired during course of his work to third party with specific authority of entity under audit or (b)when there is a legal or professional duty to disclose the information.

This obligation continues even after the end of relationship between the auditor and entity. Confidentiality is not only a matter of non-disclosure. It also implies that the auditor should neither use nor appear to use the information acquired in the course of audit for personal advantage or for the advantage of a third party.

- (3) Skills and Competence : (i)The audit should be performed and the audit report should be prepared with due professional care by persons who have adequate training, experience and competence in auditing. What constitute due professional care depends largely on the facts and circumstances of each case. However, legal provisions, judicial pronouncements and professional publications such as auditing standards help in establishing whether due professional care was exercised.

(ii) The auditor requires specialised skills and competence. Skills and competence 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. The auditor also needs to constantly update his skills and competence through continuing education. He should also be aware of developments including pronouncements of ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

- (4) Work performed by others : This principle deals with the situations when the auditor
- (i) delegates work to assistants or
 - (ii) uses work performed by other auditors and
 - (iii) uses work performed by experts.

The auditor is entitled to rely on work performed by others. However he is entitled to rely only when he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. 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. 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.

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.

- (5) Documentation : The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles. Maintenance of adequate documentation helps the auditor in proper planning, performance, supervision and review of audit. Adequate documentation also provides an evidence of the audit work performed .
- (6) Planning : 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 a 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.

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

- (7) **Audit Evidence** : The end result of the audit is to give opinion on the financial information. For this purpose auditor should obtained sufficient appropriate audit evidence. Sufficiency and appropriateness are inter-related and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained while appropriateness relates to its relevance and reliability. The auditor obtains sufficient appropriate audit evidence by the following procedure:
- (i) Compliance procedure (tests designed to evaluate the relevant internal control)
 - (ii) Substantive procedure (tests of details of transactions and balances as well as analysis of ratios and trends)

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. As it is difficult to check each and every transaction of the auditee, the auditor can rely upon the internal control system, procedure and policies of the auditee. Whether the auditee is complying with prescribed policies and procedures or not, the auditor follows a procedure to test it which is called compliance procedures.

Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. This is test of details and analytical procedure performed by the auditor.

Substantive procedures includes :

- (i) tests of details of transactions,
 - (ii) tests of balances of accounts,
 - (ii) analysis of significant ratios like gross profit ratio, expenses ratio etc. and trends including the resulting enquiry of unusual fluctuations and items.
- (8) **Accounting System and Internal Control** : Responsibility of preparation of true and fair financial statements is of the management . 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.

The auditor should understand 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 and may also differ as to their nature and timing.

- (9) Audit Conclusions and Reporting : The end result of the auditing is the expression of auditor's opinion on the financial information. The auditor's conclusion and report should be based on audit evidence obtained and his knowledge of business of the entity and should normally include 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 as may be laid down or prescribed under the 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 therefor.

7. (a) "Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's risk management and internal control system."

The Institute of Internal Auditors revised the definition of Internal Auditing as under:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process."

- (b) The objectives of internal audit can be stated as follows:

- (1) To verify the accuracy and authenticity of the financial accounting and statistical records presented to the management.
- (2) To ascertain that the standard accounting practices, as have been decided to be followed by the organisation, are being adhered to.
- (3) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.
- (4) To confirm that liabilities have been incurred only for the legitimate activities of the organisation.
- (5) To analyse and improve the system of internal check ; in particular to see (i) that it is working ; (ii) that it is sound ; and (iii) that it is economical.
- (6) To facilitate the prevention and detection of frauds.
- (7) To examine the protection afforded to assets and the uses to which they are put.
- (8) To make special investigations for management.
- (9) To provide a channel whereby new ideas can be brought to the attention of management.
- (10) To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management ; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

As per AAS-7 "Relying upon the work of an internal auditor" the scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its management.

- (c) Normally internal audit operates in one or more of the following areas :
- (i) Review of accounting system and related internal controls : The establishment of an adequate accounting system and related controls is the responsibility of management which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related internal controls, monitoring their operation and recommending improvements thereto.
 - (ii) Examination for management of financial and operating information : This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.
 - (iii) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation : Generally, the external auditor is interested in the results of such audit work only when it has an important bearing on the reliability of the financial records.

- (iv) Physical examination and verification : The would generally include examination and verification of physical existence and condition of the tangible assets of the entity.
8. (a) Representation by management refers to written or oral confirmation by management regarding the items presented in financial statements. For example if management confirms the auditor the quantity, existence and cost of inventories through a letter, such confirmation is called management representation.
- (b) As per AAS 11 “representation by Management” if management refuses to provide representations on any matter that the auditor considers necessary, this will constitute a limitation on the scope of his examination. In such circumstances, the auditor should evaluate any reliance he has placed on other representations made by management during the course of his examination and consider if the refusal may have any additional effect on his report.

In case management is not willing to give in writing the representations made by it during the course of audit, the auditor should himself prepare a letter in writing setting out his understanding of management’s representations that have been made to him during the course of audit and send it to management with a request to acknowledge and confirm that his understanding of the representations is correct. If the management refuses to acknowledge or confirm the letter sent by the auditor, this will constitute a limitation on the scope of his examination. In such circumstances, the auditor should evaluate any reliance on those representations and consider if the refusal may have any additional effect on his report.

Thus CA Tripathi should re-evaluate any reliance that he has placed on other representations made by the management during the course of audit and consider if the refusal may have any additional effect on his report (i.e. , he should consider whether he should qualify the assertion in the auditor’s report that he has obtained all information and explanations required by him and whether such a refusal would also require a qualification of his opinion as to whether the financial statements present a true and fair view).

- (c) Example of a Management Representation Letter in an Audit of Financial Statements :

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of for the year ended for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of the financial position of as of and of the results of

operations for the year then ended. We acknowledge our responsibility for preparation of financial statements in accordance with the requirements of the Companies Act, 1956 and recognised accounting policies and practices, including the Accounting Standards issued by the Institute of Chartered Accountants of India.

We confirm, to the best of our knowledge and belief, the following representations:

Accounting Policies

The accounting policies which are material or critical in determining the results of operations for the year or financial position are set out in the financial statements and are consistent with those adopted in the financial statements for the previous year. The financial statements are prepared on accrual basis.

Assets

The company has a satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial statements.

Fixed Assets

The net book values at which fixed assets are stated in the Balance Sheet are arrived at:

- (a) after taking into account all capital expenditure on additions thereto, but no expenditure properly chargeable to revenue;
- (b) after eliminating the cost and accumulated depreciation relating to items sold, discarded, demolished or destroyed;
- (c) after providing adequate depreciation on fixed assets during the period.

Capital Commitments

At the balance sheet date, there were no outstanding commitments for capital expenditure excepting those disclosed in Note X to the financial statements.

Investments

The current investments as appearing in the Balance Sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the Balance Sheet as 'long-term investments'.

Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.

In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renounced, or allowed to lapse. In no case have they been renounced in favour of third parties without consideration which has been properly accounted for in the books of account.

All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.

The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity and there are no charges against the investments of the entity except those appearing in the records of the entity.

9. (a) As per AAS 14 "Analytical procedures" means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

Analytical procedures include (i) comparison of financial information, and (ii) study of relationships.

Comparison of financial information includes (a) inter-firm comparison (e.g. comparison of the ratios of the enterprise with those of other enterprises), (b) intra-firm comparison (comparison of current information with the corresponding information for prior periods)

Study of relationships includes consideration of relationships among elements of financial information and between financial information and related non-financial information. For example study of gross margin percentage (relationships among elements of financial information) and study of the ratio of payroll costs to the number of employees (relationship between financial information and related non-financial information).

- (b) As per AAS 14 analytical procedures can be used :

- (i) At planning stage : The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk. Application of analytical procedures may indicate aspects of the business of which the auditor was unaware and will assist in determining the nature, timing and extent of other audit procedures.

Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and volume of goods sold.

- (ii) During the course of audit : During the course of audit, the auditor can apply analytical procedures to gain evidence about account balances or classes of transactions, normally in conjunction with other audit tests. During the course of audit analytical procedures can be used as substantive procedures. The objective of substantive tests is to reduce detection risk. Whether the analytical procedure can help in achieving the objective of substantive procedures (to reduce the detection risk), is a matter of judgement of auditor and expected reliability of the data gathered in analytical procedures.

- (iii) At the overall review stage at the end of audit : The auditor should apply

analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business. The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, in some cases, as a result of application of analytical procedures, the auditor may identify areas where further procedures need to be applied before the auditor can form an overall conclusion about the financial statements.

10. (a) Machinery acquired under Hire-purchase system
 - (i) Examine the Board's Minute Book approving the purchase on hire-purchase terms.
 - (ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, terms of payment and rate of purchase.
 - (iii) Ascertain that the machinery has been included in the related assets account at its cash value. Also instalments due have been paid and the hire-purchase charges applicable to the period from the commencement of the agreement to the end of the financial year have been charged against current profits.
 - (iv) Ensure that machinery acquired on hire purchase basis has been included at its cash value in the balance sheet and depreciation has been calculated on the cash value from the date of the purchase. The amount due to the hire purchase company in respect of the capital outstanding has either been shown as a deduction from the machinery account or as a separate amount under current liabilities.
- (b) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:
 - (i) Reconcile the balances in the overdraft or loan account with that shown in the pass books and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
 - (ii) Obtain a certificate from the bank showing the particulars of securities deposited with the bank as security for the loans or the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of Charges.
 - (iii) Verify the authority under which the loan or overdraft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

- (iv) Confirm, in the case of a company, that the provision contained in section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.
 - (v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the concern.
- (c) Sale Proceeds of Junk Materials
- (i) Review the internal control on junk materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.
 - (ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of junk materials.
 - (iii) Review the production and cost records for the determination of the extent of junk materials that may arise in a given period.
 - (iv) Compare the income from the sale of junk materials with the corresponding figures of the preceding three years.
 - (v) Check the rates at which different types of junk materials have been sold and compare the same with the rates that prevailed in the preceding year.
 - (vi) See that all junk materials sold have been billed and check the calculations on the invoices.
 - (vii) Ensure that there exists a proper procedure to identify the junk material and good quality material is not mixed up with it.
 - (viii) Make an overall assessment of the value of the realisation from the sale of junk materials as to its reasonableness. Ensure that proper accounting has been done for it.
- (d) Discounted Bills Receivable Dishonoured:
- (i) Obtain the schedule of discounted bills receivable dishonoured.
 - (ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.
 - (iii) Verify the bills receivable returned by the bank along with bank's advice.
 - (iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the debtor is also debited.
 - (v) Check that bank commission, if any, charged by the bank has been recovered from the party.
11. Independence of Auditor : The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

"Independence is:

- (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised."

Independence is the keystone upon which the respect and dignity of a profession is based. Independence stands for the strength of individuals to adopt an unbiased view on the matters undaunted by any favour or frown. In all matters relating to the assignment, an independence in mental attitude is to be maintained. Only so long as the auditor maintains a high standard of independence and impartiality, the audit reports will continue to be accepted and respected by business, financial institutions, Government and investors. Professional integrity and independence are essential characteristics of all the learned professions but are more so in the case of accounting profession.

Independence is a state of mind and personal character and an enlightened view of the professional duties involved. Independence is much affected by the state of the profession, i.e., the ability and willingness to enforce a proper code of ethics as well as its ability to withstand pressures. The more the esteem for the profession in the public eyes because of the standards of independence prescribed by it for its members, greater the reliance there would be on the reports and opinions given by the members of the profession. Independence is a qualitative condition but rules are often framed by professional bodies to help and guide members in preserving independence in variety of complex circumstances.

Independence of auditor must not only exist in fact, but should also appear to exist to all reasonable persons. This is very important because very often the relationships are misunderstood. It is, therefore, necessary that relationship maintained by the auditor shall be such that no reasonable man can doubt his objectivity and integrity.

The Guidance Note issued by the ICAI on "Independence of Auditors" contemplates that it is not possible to define "Independence" precisely. According to it, "independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self-interest. It stipulates that the independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered. Independence of the auditor has not only to

exist in fact, but should also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly he himself is satisfied about his client and secondly, no unbiased person would be forced to the conclusion that on an objective assessment of the circumstances, there is likely to be an abridgment of the auditors' independence. There is also a collective aspect of independence that is important to the accounting profession as a whole.

The chartered accountant is not personally known to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.

12. Using the work of another auditor (AAS 10) : AAS 10 is applicable in the situation where an auditor (principal auditor) reporting on the financial information of the entity, uses the work of another auditor (other auditor) with respect to the financial information of one or more components included in the financial information of the entity. The term 'financial information' encompasses 'financial statements. "Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

Generally when another auditor has been appointed for the component, the principal auditor would be entitled to rely upon the work of such auditor unless there are circumstances to indicate that he should not rely.

In the given case for using the work of Kumar & Associates (other auditor) with respect to the financial information of Nagpur division included in the financial information of ABC Ltd., Gupta & Associates (principal auditor) should follow the following procedure :

- (1) The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.
- (2) The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.
- (3) The principal auditor should consider the significant findings of the other auditor.
- (4) The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also

decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

- (5) The principal auditor should document in his working papers the components whose financial information was audited by other auditors; their significance to the financial information of the entity as a whole; the names of the other auditors; and any conclusions reached that individual components are not material. The principal auditor should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures.
13. (a) While pursuing the profession of audit, the auditor has to audit the financial statements of different types of business, for example, sometimes he audits the accounts of a manufacturing company, sometimes he audits the accounts of a goods storage company (like warehouse or cold storage). The nature of financial transactions and events are different in different types of business. The auditor can make better assessment/judgement while evaluating the audit evidence of the financial transactions of different types of business.

Therefore in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report. Such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures.

- (b) The auditor can obtain knowledge of the industry and the entity from a number of sources. For example:
- (1) Previous experience with the entity and its industry.
 - (2) Discussion with people with the entity (for example, directors and senior operating personnel).
 - (3) Discussion with internal audit personnel and review of internal audit reports.
 - (4) Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry.
 - (5) Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers and suppliers).
 - (6) Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and institutions and financial newspapers).
 - (7) Legislation and regulations that significantly affect the entity.

- (8) Visits to the entity premises and plant facilities.
 - (9) Documents produced by the entity (for example, minutes of meetings, material sent to shareholders or furnished to regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manual, manuals of accounting and internal control systems, chart of accounts, job descriptions, marketing and sales plans).
14. (a) Related party has been described in AS 18 'Related Party disclosures' . As per AS 18 related party relationship is described as below :
- (1) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);
 - (2) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;
 - (3) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;
 - (4) key management personnel; and relatives of such personnel; and
 - (5) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

In the context of AS 18, the following are deemed not to be related parties:

- (1) two companies simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings);
- (2) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and
- (3) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):
 - (i) providers of finance;
 - (ii) trade unions;
 - (iii) public utilities;

- (iv) government departments and government agencies including government sponsored bodies.
 - (b) The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:
 - (1) review his working papers for the prior years for names of known related parties;
 - (2) review the entity's procedures for identification of related parties;
 - (3) inquire as to the affiliation of directors and key management personnel, officers with other entities;
 - (4) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;
 - (5) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;
 - (6) inquire of other auditors of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;
 - (7) review the entity's income tax returns and other information supplied to regulatory agencies; and
 - (8) review the joint venture and other relevant agreements entered into by the entity.
15. (a) Buy Back of Own Securities: Section 77A of the Companies (Amendment) Act, 1999 contains elaborate provisions enabling a company to buy-back its own securities.
- The auditor should ensure the compliance of all the provisions relating to buy-back and also see that proper accounting entries have been passed. Audit procedure to be followed may be as under:
- (i) Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.
 - (ii) Check authorisation in the Articles of Association which is a prerequisite of any buyback.
 - (iii) Examine special resolution passed in the general meeting authorising buyback.
 - (iv) Ascertain that quantum of buy-back is either equal to or less than 25% of the total paid up share capital and free reserves but in case of buy-back of equity shares in any financial year it should not exceed 25% of its total paid-up equity

capital in that financial year.

- (v) Check that the debt equity ratio should not be more than 2 : 1 except in cases where Central Government allows higher ratio for a class or classes of companies.
 - (vi) Ensure that shares or other specified securities to be bought back should be fully paid-up.
 - (vii) Buy-back should be completed within 12 months from the date of passing the special resolution.
 - (viii) Ascertain that declaration of solvency in Form No.4A was filed with the SEBI and/or the Registrar of Companies before making buy-back but subsequent the passing of the special resolution.
 - (ix) See that SEBI (buy-back of securities) Regulations, 1998 have been followed by listed company.
- (b) Option on Share Capital : Part I of Schedule VI to the Companies Act, 1956, requires disclosure of the particulars of any option on unissued share capital.

An option on shares arises when a person has acquired a right under an agreement with the company to subscribe for shares in the company if he so chooses. Such options generally arise under the following circumstances.

Under the promoters agreement, subsequently ratified by the Collaboration agreement;

Loan agreements, debenture deeds (section 81 of the Companies Act)

Agreements to convert preference shares into equity shares; Other contracts, such as for supply of capital goods and or merchandise.

The auditor should ensure the compliance of the legal provisions and proper disclosure as required by Part I of Schedule VI the Companies Act, 1956 and also verify it with the agreement or contract regarding option on share capital.

16. (a) Share Capital: The Share Capital should be classified into :

- (a) Authorised Capital.
- (b) Issued Capital.
- (c) Subscribed Capital.

Under "Authorised Capital", the various classes of shares should be distinguished and the particulars of the numbers of shares and the face value of shares for each class should be stated. The particulars of the different classes of preference shares should also be given. The Particulars of any option on unissued share capital have to be specified.

Under "Subscribed Capital", the following particulars should be given.

- (i) The various classes of shares should be distinguished and particulars of the

different classes of preference shares should be stated.

- (ii) Number of shares.
- (iii) Face value of shares.
- (iv) Amount called up.

In the balance sheets of subsidiary companies the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated. However, the auditor is not required to certify the correctness of such shareholdings as certified by the management.

The number of shares allotted as fully paid up pursuant to a contract without payments being received in cash should be shown separately. Even in respect of such shares a separate mention must be made of the shares which are allotted as fully paid up by way of bonus shares. In case of bonus shares, the source from which such shares are issued, e.g., capitalisation of profits or reserves or from Share Premium Account, should be specified.

The unpaid calls should be deducted from the Subscribed Capital and should be analysed as under:

- (i) Due by directors.
- (ii) Due by others.

The amount originally paid up on the forfeited shares should be added to the Subscribed Capital. Any capital profit on reissue of forfeited shares should be transferred to a Capital Reserve.

Under the item "Share Capital", it is necessary to disclose :

- (i) In respect of Redeemable Preference shares, the terms of redemption or conversion together with the earliest date of redemption or conversion, and
- (ii) the particulars of any option on unissued share capital.

It should be noted that Share Premium Account should not be shown under "Share Capital", as it is required to be shown under "Reserves and Surplus".

- (b) Contingent Liabilities: Under the head "Contingent Liabilities", the items should be classified as under :
 1. Claims against the company not acknowledged as debts.
 2. The uncalled liability on shares partly paid.
 3. Arrears of fixed cumulative dividends.
 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.

In respect of arrears of fixed cumulative dividends, the following details should be given :

- (i) the period for which the dividends are in arrears showing separately such arrears on each class of shares;
- (ii) the amount should be stated before deduction of income-tax, but in the case of tax-free dividends the amount should be shown free of income-tax and the fact that it is so shown should be stated.

Under sub-head 5, the amount of guarantees given by the company on behalf of directors or other officers of the company should be stated and where practicable, the general nature and the amount of each such contingent liability, if material, should be specified. Examples of other contingent liabilities are:

- (i) Liability on Bills of Exchange discounted but not maturing on the balance sheet date.
- (ii) Liability in respect of suits pending in the Court.
- (iii) Dispute in regard to bonus, etc.
- (iv) Matters referred to arbitration.

(c) Investments : This item should be classified as under :

1. Investments in Government or Trust securities.
2. Investment in shares, debentures or bonds.
3. Immovable properties.
4. Investments in the capital of partnership firms.
5. Balance of unutilised monies raised by issue.

Under item (2) above, investments in shares, debentures or bonds of subsidiary companies should be separately stated.

In respect of all investments in shares, there should be shown separately, shares, fully paid up and partly paid up and the different classes of shares should be distinguished.

The nature of investments should be disclosed and where the investments are earmarked, the fund which such investments represent should be stated.

In each case, the mode of valuation, e.g., cost or market value should be stated.

The aggregate amount of a company's quoted investments together with the market value thereof and the aggregate amount of a company's unquoted investments should be shown separately.

The interest accrued on investments should be shown under the heading "current assets" and not under this head.

Section 372(10) provides that every investing company shall annex to each balance sheet prepared by it a statement showing the bodies corporate (indicating separately the bodies corporate in the same group) in the shares of which investments have been made by it (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each body corporate. However, in case of an investment company, it is sufficient if the statement shows only the investments existing as on the date of the balance sheet.

A statement of investments (whether shown under "investments" or under "current assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance-sheet.

A "trade investment" means an investment by a company in the shares or debentures of another company, not being its subsidiary, for the purpose of promoting the trade or business of the first company.

The said statement should show the names of the bodies corporate, indicating separately the names of the bodies corporate under the same management in whose shares or debentures, investments have been made. The nature and extent of the investments so made in each body corporate should be given.

Such statement should include all investments whether existing or not, made subsequent to the date as at which the previous balance sheet was made out. In case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it will be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out.

In regard to the investments in the capital of partnership firms, the names of firms, with the names of all their partners, total capital and shares of each partner should be given in the statement annexed to the balance sheet.

Where the company's debentures are held by a nominee or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated. This disclosure will enable a shareholder to ascertain how much profit the company will make if the debentures purchased by the company were to be cancelled.

All un-utilised monies out of the issue must be separately disclosed in the Balance Sheet of the Company indicating the form in which such unutilised funds have been invested.

(d) Secured Loans: This item should be classified as follows :

1. Debentures.
2. Loans and Advances from Banks.
3. Loans and Advances from subsidiaries.

4. Other Loans and Advances.

The nature of the security should be specified in each case. The interest accrued and due on "Secured Loans" should be included under the appropriate sub-heads under the head "Secured Loans", but the interest accrued but not due on secured loans is required to be shown under "Current Liabilities".

The loans from directors and manager should be shown separately. Where loans have been guaranteed by managers and/or directors, a mention thereof should be made and the aggregate amount of such loans under each head should be shown separately.

In respect of debentures, the terms of redemption or conversion and the earlier date of redemption or conversion should be stated. The particulars of any redeemed debentures which the company has power to re-issue should be given.

In case where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company should be stated. This information may be given under the head "Investments".

17. Section 224(6) of the Companies Act, 1956 deal with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instance case, Mr Y has been validly appointed and thereafter he had resigned.

Thus a casual vacancy had been created on account of resignation. The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case), the Board cannot fill in that vacancy. The company in a general meeting can only fill the same.

Thus, in this case XYZ Ltd will have to call an extra-ordinary general meeting (EGM) and appoint another auditor. The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

The provisions of the Companies Act, 1956 applicable for the appointment of an auditor in place of a retiring auditor would equally applicable in the instant case are given below:

- (i) Section 225(1): Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor.
- (ii) Section 190(2): Special notice is to be sent to all members of the company at least 7 days before the date of the AGM.
- (iii) Section 225(2): On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- (iv) Section 225(3): Representation if any, received from the retiring auditor should

be sent to the members of the company.

- (v) Section 224A: Special resolution as required under this section should be duly passed.
 - (vi) Section 224(1B): Before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate is to be obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in Section 224(1B).
 - (vii) The incoming auditor should also satisfy himself that the notice provided for under Sections 224 and 225 has been effectively served on the outgoing auditor.
18. For the purpose of AAS 27 "Communications of Audit Matters with Those Charged with Governance", "audit matters of governance interest" are those matters that arise from the audit of financial statements and are, in the opinion of the auditor, both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with auditing standards generally accepted in India, to design procedures for the specific purpose of identifying matters of governance interest.

Such matters may include:

- ◆ The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- ◆ The selection of or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
- ◆ The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- ◆ Adjustments to financial statements arising out of audit that have, or could have, a significant effect on the entity's financial statements;
- ◆ Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- ◆ Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;
- ◆ Expected modifications to the auditor's report;
- ◆ Other matters warranting attention by those charged with governance, such as

material weaknesses in internal control, questions regarding management integrity, and fraud involving management;

Any other matters agreed upon in the terms of the audit engagement.

19. (a) a Computer Information Systems environment exists when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data. Those computers may be operated by the entity or by a third party.
- (b) The overall objective and scope of an audit does not change in a CIS environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity. Accordingly, a CIS environment may affect:
 - ◆ the procedures followed by the auditor in obtaining a sufficient understanding of the accounting and internal control system.
 - ◆ the auditor's evaluation of inherent risk and control risk through which the auditor assesses the audit risk.
 - ◆ the auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective.

Therefore the overall objectives and scope remain the same in a CIS environment.

- (c) As per AAS 29 " audit in a Computer Information Systems Environment" the auditor should document the audit plan, the nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained. In an audit in CIS environment, some of the audit evidence may be in the electronic form. The auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required.
20. (a) Operational Audit: Operational Audit involves examination of all operations and activities of the entity.

The objects of operational audit include the examination of the control structure and of the relation of department controls to general policies. It provides an appraisal of whether the department is operating in conformity with prescribed standards and procedures and whether standards of efficiency and economy are maintained. It is concerned with formulation of plans. Their implementation and control in respect of production and marketing activities.

Traditionally, internal audit focused on accounting operations of the entity. However, operational audit covers all other operation such as marketing, manufacturing, etc.

Thus, operational audit in its initial stages developed as an extension of internal auditing. The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation.

Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey.

- (b) The reliability of audit evidence depends on its source-internal or external, and on its nature-visual, documentary, or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence:
- (i) External evidence (e.g. confirmation received from third party) is usually more reliable than internal evidence.
 - (ii) Internal evidence is more reliable when related internal control is satisfactory.
 - (iii) Evidence in the form of documents and written representations is usually more reliable than oral representations.
 - (iv) Evidence obtained by the auditor himself is more reliable than that obtained through the entity.
- (c) Audit Programme: An audit programme is a detailed plan of applying the audit procedure in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. It is framed keeping in view the nature, size and composition of the business, dependability of the internal control and the given scope of work. Audit programme provides sufficient details to serve as a set of instructions to the audit team and also helps to control the proper execution of the work. On the basis of experience while carrying out the audit work, the programme may be altered to take care of situations which were left out originally, but found relevant for the particular audit situation. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, that may be dropped. There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. For the purpose of framing an audit programme the following points should be kept in view:
- ◆ Audit objective

- ◆ Audit procedure to be applied
 - ◆ Extent of check
 - ◆ Timing of check
 - ◆ Allocation of work amongst the team members
 - ◆ Special instructions based on past experience of the auditee
- (d) Cut-off Transactions relating to Inventories: Cut-off transactions imply a set of procedures applied to ensure separation of one year's transaction from those of the following year. An auditor is expected to devote his attention to the procedures followed by the management regarding cut-off. The auditor should satisfy himself that these procedures adequately ensure that (i) goods purchased for which property has passed to the client have in fact been included in the inventories and that the liability has been provided for; and (ii) goods sold have been excluded from the inventories and credit has been taken for the sales.