Verification of Assets and Liabilities

**BASIC CONCEPTS**

| Verification | ➢ Verification is a process to verify the ownership, valuation, possession and existence of a particular Asset or liability.  
 ➢ Verification establishes the correspondence of actual facts or details with those represented in accounts.  
 ➢ Verification relates to the assets and liabilities appearing in the balance sheet.  
 ➢ Verification is generally carried out at the end of year.  
 ➢ To confirms the existence, ownership, possession, completeness, valuation and disclosure of items relating to balance sheet.  
 ➢ Verification is based on observation as well as documentary examination.  
 ➢ Verification requires experienced people and done by the senior staff.  
 ➢ Verification includes valuation |

Question 1

Comment on “The cash-book showed a huge cash balance on hand consistently throughout the year”.

**Answer**

**Maintenance of Huge Cash Balance**: Cash balance is maintained to meet the day to day operational needs of an organisation. So the auditor has to perform audit procedures particularly having regard to the fact that maintaining such huge balance is highly prone to misappropriation and other forms of fraud.

Accordingly, if the entity is consistently maintaining huge cash balance, which is not justified by its operational requirement needs, the Guidance Note on Audit of Cash and Bank Balances
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recommends that the auditor should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balance as shown by the books.

If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

Question 2

(a) Comment on the “Responsibility for properly determining the quantity and value of inventories rests with the management of the entity”.

(b) How would an auditor proceed to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory? Also state reporting requirements for the same in the case of a company.

Answer

(a) Responsibility for Determining Quantity and Value of Inventories: The Guidance Note on Audit of Inventories specifies that the responsibility for properly determining the quantity and value of inventories rests with the management of the entity. Therefore, it is the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all owned by the entity.

The management can satisfy this responsibility by carrying out appropriate procedures such as verification of all items of inventory at least once in every financial year. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. He is also required to determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items are well-designed and operate properly.

This responsibility of the management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. The entities usually maintain detailed inventory records in the form of Stores/Inventory ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case. In valuation aspects, compliance with AS 2 should also be ensured.
(b) As per SA 501 on “Audit Evidence- Specific Considerations for Selected Items”, the following principles are laid down in this respect:

(i) When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) Attendance at physical inventory counting, unless impracticable, to:

   (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting;

   (ii) Observe the performance of management’s count procedures;

   (iii) Inspect the inventory; and

   (iv) Perform test counts; and

(2) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.

(ii) If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures as stated above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

(iii) If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

(iv) If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705.

(v) When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

   (1) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

   (2) Perform inspection or other audit procedures appropriate in the circumstances.

Audit Conclusions and Reporting: As per clause (ii) of Para 3 of Companies (Auditor’s Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.
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.

Question 3

As an auditor, what would you do in the following situations?

(a) The method of depreciation on plant and machinery is to be changed from SLM basis to WDV basis from the current year.

(b) The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year.

Answer

(a) Change in the Method of Depreciation: As per Accounting Standard 6 “Depreciation Accounting”, the method of depreciation should be applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if:

(i) The adoption of the new method is required by statute (or)

(ii) For compliance with an accounting standard (or)

(iii) It is considered that the change would result in a more appropriate presentation of financial statements of the enterprise.

Therefore, the auditor must ensure that the change in method of depreciation on plant and machinery from SLM to WDV basis from the current year is made in accordance therewith. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. Further, it should be ensured that the deficiency (since change is from SLM to WDV) arising to be adjusted in the year of change by way of a charge to the Statement of Profit and Loss. The auditor may also ascertain that the change in the method and the effect thereof on the profits of the entity is quantified and disclosed. If it is not done by the management, the auditor has to bring it to the notice of the shareholders through qualification in the audit report.

(b) Semi-Finished Goods Lying With Third Parties: Semi-finished goods are the assets of the company and therefore such goods, though, at present not with the company, should be included in the closing inventory under the head “inventory with processors”. The auditor shall be required to undertake the following steps in respect of inventories lying with third parties:

(i) Ensure that semi-finished goods have been included for valuation of inventory since these belong to the company.
(ii) Obtain confirmation letters from such third parties in respect of quantity lying with them at the end of the year. The auditor may also consider carrying out the appropriate audit procedure to obtain assurance about the condition of such inventory.

(iii) Examine the basis of valuation. In this case, it shall have to be done on the basis of the cost of work-in-progress and having regard to stage of completion and accordingly accounting for conversions costs.

(iv) Check that the disclosure requirements as specified in Schedule III to the Companies Act, 2013 and AS 2 “Valuation of Inventories” have been followed.

Question 4

Give your comments and observations on the following:

(a) Balance confirmations from trade receivables/trade payables can only be obtained for balances standing in their accounts at the year-end.

(b) The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.

(c) Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses.

Answer

(a) **Confirmation of Balances:** Direct confirmation of balances from trade receivables/trade payables in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor.

“Guidance Note on Audit of Debtors, Loans and Advances” issued by the ICAI recommends that the trade receivables may be requested to confirm the balance either:

(i) As at the date of the balance sheet; or

(ii) As at any other selected date which is reasonably close to the date of the balance sheet.

The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the trade receivables at a date other than the balance sheet date, he should examine the movements in trade receivable balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that trade receivable balances stated in the balance sheet are not materially mis-stated.

Therefore, it is not necessary that balances of trade receivables/trade payables should necessarily be verified only at the end of the year only. In fact, in order to incorporate an element of surprise, the auditor may consider different confirmation dates periodically,
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i.e., December 31 as a cut-off date in one year and June 30 in another year and so on. Therefore, the statement that balance confirmation from trade receivables/trade payables can only be obtained for balances standing in their accounts at the year-end is not correct.

(b) **Certificate from a Management’s Expert:** The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of a management’s expert. SA 500 on “Audit Evidence” also states that the preparation of an entity’s financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. It further requires the auditor to evaluate the competence, capabilities and objectivity of that expert; obtain an understanding of the work of that expert; and evaluate the appropriateness of that expert’s work as audit evidence for the relevant assertion, to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of SA 500 before relying upon the certificate obtained by the management from the actuary.

(c) **Revaluation of Fixed Assets:** The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS 10 on ‘Accounting for Fixed Assets’ requires that “an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution”. Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

Question 5

State briefly the duty of an auditor with regard to each of the following:

(a) **No depreciation has been charged for the year ended 31st March 2016, in respect of a spare Bus purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year.**
A sum of ₹10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing ₹8,00,000. The amount is credited to the Purchases Account.

Cost of structural alterations amounting to ₹60,000 to self-owned factory premises has been charged to Building Repairs.

A loss of ₹2,00,000 on account of embezzlement of cash was suffered by the company and it was debited to Salary Account.

**Answer**

(a) **Depreciation on Stand-by Asset:** As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the spare bus was kept ready for use as stand-by, it means it was intended to be used for the purpose of business. Depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31st March, 2016. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

(b) **Claim Received from an Insurance Company:** AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period. The claim for loss of goods in transit is arising out of ordinary activities of the enterprise as a part of its normal course of business. However, the cost of goods lost in transit is only ₹8,00,000 while the insurance money received is ₹10,00,000. Purchases Account need not be credited since it would distort the purchases done during the year and as also the gross profit. Therefore, entire amount of ₹10 lacs needs to be taken to Statement of Profit and Loss under an appropriate head. This is an income arising from an ordinary activity of the enterprise but having regard to amount involved and exceptional nature, a separate disclosure is to be made in the Statement of Profit and Loss. Such disclosure would enable the users to understand the performance of an enterprise for the period.

(c) **Cost of Structural Alterations:** Any subsequent expenditure on fixed assets which increases the profitability or capacity arising from them beyond their previously assessed standards of performance amounts to capital expenditure and, thus, must form part of the cost of the asset. The words "structural alteration" would generally signify that some significant changes have taken place in the design of building to provide more strength to the building or expansion in the capacity of the building. Therefore, cost of ₹60,000 represents the cost of expansion or extension or may increase the life span of premises, it is a capital expenditure, and an adjustment entry debiting Buildings Account and
crediting Building Repairs Account should be made and depreciation should also be provided accordingly.

(d) **Embezzlement of Cash:** AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", requires that "all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period". It further states that "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Embezzlement of cash during the course of business is a 'business loss'. It is a business hazard which can occur once in a while. Being material item, it is required to be disclosed under a distinct head in the Statement of Profit and Loss.

**Question 6**

*Explain the difference between Depreciation and Fluctuation in Value.*

**Answer**

**Depreciation and Fluctuation in Value:** Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. It directly affects the earning capacity of an asset. Hence, it is a charge against the profit of the year.

Fluctuation, on the other hand, is a temporary shrinkage or decrease and increase in the value of an asset usually due to external causes such as rise and fall in market price of an asset. But the fluctuation does not affect the earning capacity or working life of an asset. Hence, it is not taken into account and no charge is made against the profit of the year.

Depreciation is only in connection with fixed assets while fluctuation is usually in connection with current assets. Depreciation generally means fall in the value of fixed asset while fluctuation may mean either increase or decrease in the value of any asset, current as well as fixed. Depreciation has a significant effect determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

**Question 7**

*State how would you verify the Buildings.*

**Answer**

**Verification of Building:**

(i) Examine the title deeds of buildings to see whether the client holds the title on the balance sheet date. If the property has been mortgaged, the title deeds will be in the possession of the mortgagee, from whom a certificate should be obtained to that effect.
(ii) Verify the original cost of buildings by reference to the deed of conveyance. If the building is constructed by the client, verify the original cost by reference to the cost as recorded in the books of account of the year in which the construction was completed.

(iii) Verify that appropriate depreciation has been provided against the buildings. In case no depreciation is provided on the buildings, a note to this effect should be given in the Statement of Profit and Loss.

(iv) See the appropriate lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc. Also ensure that all covenants in the lease deed have been fulfilled by the client.

(v) See that the buildings have been valued at cost less depreciation. If any revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made. In case of a company, the requirements of Schedule II and III to the Companies Act, 2013 shall also be complied with.

(vi) See that the relevant particulars of buildings have been entered in the fixed assets record maintained by the client.

Question 8
(a) Explain the meaning of the term “subsequent events” as used in the SA 560.
(b) Should all type of subsequent events be considered by the auditor in his attest function?
(c) Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in the financial statements.

Answer
(a) Meaning of Subsequent Events: SA 560 on “Subsequent Events” defines the term “subsequent events” as events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report. “Subsequent events” also refer to significant events which occurred up to the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor.

(b) Consideration of Subsequent Events by the Auditor: SA 560 on “Subsequent Events” requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor’s report. However, the exact manner of treatment would depend upon whether the event falls in the category of ‘adjusting event’ or ‘non-adjusting event’. As per Accounting Standard (AS) 4, events occurring after the date of the balance sheet are of two types, viz., adjusting events which provide further evidence of conditions that existed at the date of the balance sheet; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the date of the balance sheet.
Therefore, an auditor is required to consider all subsequent events while discharging his duties and determine whether those shall have to be adjusted or simply required to be disclosed. However, the auditor should perform work as near as practicable to the date of the auditor's report.

(c) Audit Procedures: The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. The procedure to identify “subsequent events” requiring adjustment or disclosure in financial statements as laid down in SA 560 is as under-

(1) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(2) Inquiring of management and, where appropriate, those change with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether there have been any developments regarding contingencies.
- Whether there have been any developments regarding risk areas and contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

(a) Reading minutes, if any, of the meetings, of the entity’s owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
(b) Reading the entity’s latest subsequent interim financial statements, if any.
(c) Read the entity’s latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
(d) Inquire, or extend previous oral or written inquiries, of the entity’s legal counsel concerning litigation and claims; or
(e) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

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

Question 9
Write a short note on “Contingent Liability”.

Answer

Contingent Liability: Accounting Standard (AS) 29 on ‘Provisions, Contingent Liabilities and Contingent Assets’, defines-

‘Contingent Liability’:

(a) is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
(b) is a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made.

‘Possible Obligation’ – an obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not probable.

‘Present Obligation’ – an obligation is a present obligation if based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Contingent liability should not be recognised but disclosed if the possibility of an outflow of resources embodying economic benefits is not remote and the amount of obligation cannot be measured with sufficient reliability to be recognised as a provision. Contingent liability should be continually reviewed and if it becomes probable that an outflow of future economic benefits will be required, then contingent liability should be recognised as a provision.
As per Schedule III (of the Companies Act, 2013), the Contingent Liabilities have to be presented in notes to accounts in the following manner:

**Contingent liabilities and commitments (to the extent not provided for):**

(i) Contingent liabilities shall be classified as:
   - (a) Claims against the company not acknowledged as debt;
   - (b) Guarantees;
   - (c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:
   - (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
   - (b) Uncalled liability on shares and other investments partly paid
   - (c) Other commitments (specify nature).

**Question 10**

*How will you vouch and/or verify the following:*

(a) **Retirement Gratuity to Employees.**

(b) **Sale Proceeds of Junk Materials.**

(c) **Assets Abroad.**

**Answer**

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

   (i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

   (ii) Verify computation of liability of gratuity on the aggregate basis.

   (iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

   (iv) See that the annual premium has been charged to the Statement of Profit and Loss.

   (v) Ensure that the accounting treatment is in accordance with AS 15 “Employee Benefits”.

(b) **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.
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(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.

(c) Assets Abroad:

(i) Examine the title deeds of immovable properties abroad.

(ii) Ensure that the immovable properties abroad have been properly classified and disclosed.

(iii) Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document.

(iv) Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.

Question 11

How will you vouch and/or verify the following:

(a) Consignment sales.

(b) Royalties received.

Answer

(a) Consignment Sales: Ascertain that credit has been taken only for the profit on the goods sold through the consignee before the year end. No profit should be taken for the profit on goods remaining in the hands of the consignee.

Verify credits in the Consignment Account with the help of the Account Sales received from the consignee. The gross sale proceeds should be credited to the Consignment Account and debited to the consignee’s account.
Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the Consignment Account and credited to the Consignee’s A/c. The Account Sales also must be correspondingly checked.

Ensure that the inventory lying with the consignee at the end should be taken in the balance sheet at cost on a consistent basis and credited to the Consignment A/c to arrive at the result of the consignment transactions.

Obtain confirmation of the balance in the account of the consignee from the consignee. Sometimes, the goods are consigned not at cost but at an inflated price. The auditor should see that the necessary adjustments to remove the loading are made at the end of the year.

Ensure that the goods consigned are not treated as ordinary sales. In cases it is so, the auditor should see that necessary adjustments are made at the year-end in respect of the unsold goods, commission and the expense incurred by consignee. The consignee should not be shown as a trade receivable for unsold goods and in valuation of inventory, these goods should be included in inventory at cost worked out on a consistent basis.

(b) Royalties Received:

(i) Verify the relevant contract and ascertain the provisions relating to the conditions of royalty such as rate, mode of calculation and due date.

(ii) Check the periodical statement received in respect of books printed, sold and inventory lying at different locations.

(iii) Check the computation in the royalty statement and ensure that any deduction or adjustment made from the royalty due is as per agreement conditions.

(iv) Verify the provisions for the royalty to be received as at the end of the year.

Question 12

Write short notes on the following:

(a) Outstanding Assets.

(b) Extent of Reliance on Analytical Procedures.

(c) Purpose of providing depreciation.

Answer

(a) Outstanding Assets: It is a well accepted accounting principle that all expenditure pertaining to the year alone should be charged against year’s revenue and all income whether received or not should be accrued for the year. Following this principle one has to make certain year-end adjustments in the books of account and outstanding assets are brought to book in that process. If expenditure has been made on certain revenue heads, the benefit of which is to be derived even after the year is over and adjustment is made to the original figure of expenditure so as to carry forward the sum that does not
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pertain to the year an outstanding asset is created. Similarly, if certain income has accrued for the year but has not been received, the amount that has so accrued is usually brought into books as year-end adjustment and thereby creating an outstanding assets account.

Generally, outstanding assets are those items for which amounts are yet to be received though services, etc. have been rendered, or items for which benefit of service will be received later. For example, in case insurance amount has been paid in advance then the proportion thereof applicable to the period subsequent to the date of the balance sheet should be calculated and shown as an outstanding assets. Other examples of outstanding assets may include rent receivable, commission receivable, advertising amount paid in advance, interest receivable on loans, etc.

(b) Extent of Reliance on Analytical Procedures: As per SA 520 “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. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor’s assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(i) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

(ii) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectability of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers’ accounts;

(iii) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and

(iv) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.
The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The tests of accounting-related controls. For example, an entity in establishing recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

(c) Purpose of Providing Depreciation: According to AS 6 on Depreciation Accounting, depreciation may be defined as, "a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined". This is a measure of the exhaustion of the useful life of an asset during the accounting period. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount irrespective of an increase in the market value of fixed assets. The principal objective of depreciation on fixed assets is to allocate as an expense, the related depreciation amount on a year to year basis. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. The main purpose of providing depreciation is as under:

(i) To keep intact the capital invested in fixed assets - This is accomplished by retaining the amount of depreciation charged in the Statement of Profit and Loss in the business.

(ii) To ascertain the true cost of production - As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.

(iii) To determine the profit or loss for the year - Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the Statement of Profit and Loss for determining the profit or loss during a year.

(iv) To present a true and fair value of entity's assets in the balance sheet, since the original costs of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the Statement of Profit and Loss representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.

**Question 13**

How will you vouch and/or verify the following:

(a) Contingent Liabilities.
(b) **Excise Duty.**

(c) **Endowment Policies.**

**Answer**

(a) **Contingent liabilities:** Accounting Standard (AS) 29 on ‘Provisions, Contingent Liabilities and Contingent Assets’, defines ‘Contingent Liability’ as a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or as a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made.

The auditor may take following steps to vouch or verify the contingent liabilities:

(i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.

(ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.

(iii) Scrutinise the lawyer’s bills to track unreported contingent liabilities.

(iv) Examine bank letters in respect of bills discounted and not matured.

(v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.

(vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.

(vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.

(viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, “Provisions, Contingent Liabilities and Contingent Assets”.

(b) **Excise Duty:** Excise duty is levied on manufacture. The liability for duty arises only at the point of time at which manufacturing is complete. The point of time at which duty is collected may be determined by consideration of administrative convenience. Normally excise duty is paid before the issue of excisable goods from the factory. For this, the auditor should take into consideration-

(i) Ensure that excise duty is paid at the time of issue of excisable goods from the godown at factory of the producer. The duplicate copy of the challan as issued by the bank is forwarded for the purpose of issue of the excisable goods.

(ii) Verify the amount of duty paid with the corresponding value of the goods issued from the inventory register of the producer by applying test check. In case where the
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client maintains an advance deposit with Excise Department, the auditor should see that the permits are issued for delivery of the goods against the advance deposit and corresponding adjustment.

(iii) Ascertain the rates of excise duty and apply it to the total sales and see that the amount actually paid does not exceed the amount thus calculated.

(iv) Ascertain that in case of dispute about the amount of duty payable, a provisional amount may be paid in lieu of final amount. In such cases, the final amount determined as payable should be verified. If the provisional payment was more than the actual amount, the refund of such excess amount should be vouched.

(v) The auditor may also physically verify requisite registers maintained with actual and see reconciliation of financial records with sales tax records.

(c) Endowment Policies:

(i) Ascertain the specific purpose for which the endowment policy is taken, e.g., Sinking Fund policies for redemption of debentures, redemption of leases or policies taken for other similar purposes, etc.

(ii) Verify the terms and conditions of policies and ensure that all such conditions are in force and being followed.

(iii) Check that premium has been deposited in time and the policy is in force.

(iv) Examine that proper disclosures have been made in the financial statements in respect of items for which the policy has been taken.

Question 14

Write short notes on the following:

(a) Intangible Assets.
(b) Floating Charge.

Answer

(a) Intangible Assets: An intangible asset is an asset which does not have a physical identity but which is used by the enterprise for production or supply of goods or for retails to other or for administrative purpose. Such asset does not have any physical existence but their presence in the business is indicated with a value placed thereon. These assets include rights and benefit to owners subject to their being useful. For example: goodwill, patents, copyright etc. AS 26, “Intangible Assets”, applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This standard also applies to rights under licensing agreements for items such as motion picture films, video recordings,
plays, manuscripts, patents and copyrights. An intangible asset should be measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any impairment losses.

Auditor should also ensure that proper disclosure is made in the financial statements about the carrying amount, amortisation methods, useful lives, etc.

(b) **Floating Charge**: Floating charge refers to a general charge on some or all the assets of an enterprise which is not attached to any specific assets and is given as a security against a debt. It has the effect of creating an immediate charge on the property of the company leaving the company to deal with the same in the ordinary course of business, but subject to the limitations imposed in the instrument of creating the charge. The floating charge, however, becomes fixed or crystallized and the trade payable becomes entitled to proceed against the assets on which the charge was created, on violation of any of the terms of the instruments creating the charge. This charge is also required to be registered within 30 days of its creation under section 77 of the Companies Act, 2013 in the case of a company.

**Question 15**

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

(a) You are the Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 20th July. The Sales Ledger balance at 31st March was ₹ 95,000. By 20th July ₹ 65,000 only had been received against this amount as full and final payment.

(b) A Computerised Machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that they would use the machinery equally and show in their Balance Sheets, 50% of the value of the machinery and charge 50% of the depreciation in their respective books of accounts.

**Answer**

(a) **Consideration of Subsequent Events**: SA 560 “Subsequent Events” requires that the auditors should consider the effect of subsequent events on the financial statements and the auditor’s report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements. AS 4 “Contingencies and Events Occurring After the Balance Sheet Date” also classifies an adjusting event which provides further evidence of conditions that existed at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of trade receivables as also the realisability aspect. The auditor’s duties in respect of trade receivables remaining uncollected at the time of giving audit report involves examination of actual past experience of collections.
from trade receivables. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31. Accordingly, the auditor would have now to see that in respect of outstanding amount of ₹ 30,000, whether the amount of provision needs any revision.

(b) **Joint Assets:** AS 10, "Accounting for Fixed Assets", issued by the Institute, prescribes that in case of fixed assets owned jointly by enterprises, the extent of the entity’s share in such assets, and the proportion in the original cost, accumulated depreciation and written down value should be stated in the Balance Sheet. Accordingly, the treatment followed by the companies reflecting 50% of the value of the machinery and changing 50% depreciation in their respective books of account is proper. However, such jointly owned assets should be indicated separately in the Fixed Assets Register maintained by the company.

(Note: Alternatively, AS 10 also recommends that the pro-rata cost of such jointly owned assets may be grouped together with similar fully owned assets and appropriate disclosure of the same should be made.)

**Question 16**

*How will you vouch and/or verify the following:*

(a) **Personal expenses of directors met by the company.**

(b) **Preliminary expenses.**

(c) **Advances given to suppliers.**

**Answer**

(a) **Personal Expenses of Directors:**

(i) Check the articles of association, service contract, minutes of general meeting, etc., to check the authorisation for such payment.

(ii) Enquire to ensure that personal expenses are not camouflaged in any other revenue items as contemplated under section 143(1) of the Companies Act, 2013.

(iii) Ascertain compliance with disclosure according to requirements of Schedule III to the Companies Act, 2013.

(iv) Check documentary evidences to examine the payments reimbursed.

(b) **Preliminary Expenses:** It is the expenditure incurred incidental to the creation, formation and floating of a company. It consists of stamp duties, registration fees, legal costs, consultants fees, expenses of printing of memorandum and articles, etc. The following should be checked-

(i) Check Board’s minutes book containing the resolution approving the expenses claimed by promoters as having been spent in formation of the company.
(ii) Examine supporting papers and vouchers, contracts, agreements, etc. to support the promoters' claims. Also check bills and receipts issued by the printer of the memorandum and articles of association, share certificates, etc.

(iii) Check receipt for the registration fee paid for registration of the company.

(iv) Verify rates of stamp required to be affixed on the memorandum and articles of association.

(v) Examine the compliance of AS 26 with regard to treatment of such preliminary expenses in the books of account.

(vi) Check that no expenses other than those what constitutes preliminary expenses are booked under this head, e.g. underwriting commission and brokerage paid.

(c) Advances to the Suppliers:

(i) Obtain schedule of debit balances in trade payables’ account and pay particular attention to the age of the balances. Also scrutinise the bought ledger.

(ii) Enquiry should be made for long unadjusted outstandings and check as to whether any of them would require provisioning.

(iii) Examine that the advances have not been shown as deposits in balance sheet as per Section 143(1) of the Companies Act, 2013.

(iv) Confirmation of balances should be obtained and reconciliation be done in case of any discrepancies.

Question 17

Write a short note on “Analytical review”.

Answer

Analytical Review: SA 500 on Audit Evidence defines analytical review as those tests of details which consists of studying significant ratios and trends and investigating unusual fluctuation and items. Thus, analytical reviews are substantive audit procedure with the help of which auditor can perform tests of details in more efficient and effective manner. Therefore, analytical reviews are nothing best analytical review procedures which have been considered at length in SA 520 on “Analytical Procedures”. According to SA 520, analytical procedures include the consideration of comparisons of the entity’s financial information with, for example, comparable information for prior periods or anticipated results of the entity, such as budgets or forecasts. Consideration of relationships among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages, between financial information and relevant non-financial information, such as payroll costs to number of employees also constitute analytical review procedures.
Analytical review procedures are used for the following purposes:

(a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

(b) as substantive procedures when their use can be more effective or efficient than tests of
details in reducing detection risk for specific financial statement assertions; and

(c) as an overall review of the financial statements in the final review stage of the audit.

The extent of reliance that the auditor places on the results of analytical review procedures
depends on materiality of the items involved, assessment of inherent and control risks, etc.

Question 18

The CC Ltd., a Pharmaceutical Company, while valuing its finished inventory at the year-end
wants to include interest on Bank Overdraft as an element of cost, for the reason that
overdraft has been taken specifically for the purpose of financing current assets like inventory
and for meeting day to day working expenses. Comment.

Answer

Cost of Inventories: As per Accounting Standard 2 “Valuation of Inventories”, cost of
inventories comprises all costs of purchase, costs of conversion and other costs incurred in
bringing the inventories to their present location and condition. However, it makes clear that
interest and other borrowing costs are usually not included in the cost of inventories because
generally such costs are not related in bringing the inventories to their present location and
condition. Therefore, the proposal of CC Ltd. to include interest on bank overdraft as an
element of cost is not acceptable because it does not form part of cost of production.

Question 19

How will you vouch/verify the following:

(a) Advertisement expenses.

(b) Goodwill.

(c) Capital work-in-progress.

(d) Wages paid to seasonal labourer.

Answer

(a) Advertisement Expenses: The following steps may be taken by the auditor to
vouch/verify the different items:

(i) Ascertaining the value of advertisement expenses to ensure that the said expense
has been properly allocated.

(ii) Examining that such expenses relate to the client’s business.
(iii) Review and examination of the complete list of media of advertisement indicating the dates, location, timing, etc., along with the amounts paid in respect of each category.

(iv) Examination of the receipts for amounts paid.

(v) Reviewing the contracts with the different agencies and ensuring that the billing conforms to the term and conditions specified therein.

(vi) Ensuring that all such outstanding expenses have been properly accounted for.

(b) Goodwill: Goodwill arises from business connections, trade name or reputation of an enterprise. AS 26, “Intangible Assets”, states that internally generated goodwill is not to be recognised as an asset, as it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. As per AS 10, “Accounting for Fixed Assets”, goodwill should be recorded in the books, only when some consideration in money or money’s worth has been paid for it. In light of the above discussions, the following points are to be noted for verification of goodwill-

(i) Examine the vendors’ agreement on the basis of which assets of the running business have been acquired by the company as per the books of account or a specific amount has been paid for the goodwill.

(ii) Ensure that whenever business is acquired at a price, payable in cash or otherwise, which is in excess of the value of net assets taken over, such excess amount is the goodwill.

(iii) Ensure that only the amount paid to the vendors not represented by tangible or intangible assets, the value of which can be measured reliably has been debited to goodwill account.

(iv) See that goodwill has not been shown in the company’s books by writing up the value of its assets, on revaluation, or by writing back the amount of goodwill earlier written off.

(v) Ensure that the goodwill not yet written off has been properly disclosed as per Schedule III requirements.

(vi) See that the goodwill is being amortised as per financial prudence over a reasonable period.

(c) Capital Work-in-Progress: Capital Work-in-Progress denotes assets under installation. This could either be plant or machinery under construction, or that construction project for establishment of a new factory is under progress. The auditor should take the following steps to verify the same-

(i) Ensure that the capital project is authorised by the Board. See the relevant Board Minutes for the purpose.
(ii) Obtain the break up in details of the amount shown in the Balance Sheet under this head.

(iii) Check purchase cost of plant machinery or other assets with reference to the contract with, and amount paid to the suppliers.

(iv) Examine the allocation of common costs to the Capital Work-in-Progress in case such items have been constructed internally.

(v) Ensure that the assets already put to commercial use are not included under Capital Work-in-Progress.

(vi) Verify that only expenses incurred up to pre commissioning stage are capitalised under this head.

(vii) Obtain the certificate of the engineering department to ascertain the quantum of the Capital Work-in-Progress, and whether the value is correctly represented in the Balance Sheet, and its transfer to Fixed Assets on completion of the project or installation of the plant.

(viii) See that Capital Work-in-Progress is properly disclosed in the Balance Sheet under the head Fixed Assets as per the presentation and disclosure requirements of Schedule III to the Companies Act, 2013.

(d) Wages Paid to Seasonal Labourers:

(i) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.

(ii) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.

(iii) Ensure that the attendance is properly checked by the Time Keeping Department.

(iv) Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis.

(v) Check the computation of wages payable to the labourers, after taking into account the deductions.

(vi) Confirm that all the payment to the labourers have been acknowledged.

(vii) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.

(viii) Reconcile the number of seasonal labourers on payroll as per the Personnel Department’s records vis-à-vis the number of labourers to whom the wages have been paid, to ensure that there are no ghost workers. This assumes greater importance, if the seasonal labourers are hired on temporary basis, and not on permanent payroll.
Question 20
As an auditor, comment on the following:

(a) As on 31.3.2016, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide satisfactory after-sales services in relation to the software purchased from it. Before finalisation of the accounts for the year ended 31.3.2016 (the accounts were finalised on 14th June, 2016), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 31.3.2016, which, it says, will be reversed in the next year.

(b) SK Ltd. has fully computerised its accounting operations. The inventory records are maintained up to date with timely entries passed for all receipts and issues. The company has hired a professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations.

Answer

(a) Events Occurring After the Balance Sheet Date: As per facts of the case on 31.3.2016, there was a claim against the company for damages by a customer for not providing after sales service. It is a condition prevailing as on the date of balance sheet. Part I of Schedule III to the Companies Act, 2013 requires disclosure of claims against company not acknowledged as debt as a footnote under caption contingent liability if the same had not been provided for in the balance sheet. However, as on that date, the company had provided for the contingent liability perhaps in view of expectation that such a claim may crystallize as liability against it. The winning of the case by the company in its favour (before the accounts were approved) after the date of the balance sheet constitutes additional evidence that will be of help in deciding the treatment of the matter in the accounts as per AS 4, “Contingencies and Events Occurring After the Balance Sheet Date”. However, no provision would be needed as the case had been won by the company, since confirmed by subsequent event happening after the balance sheet date. The disclosure of facts of the case is, however, necessary with a view to keeping users of financial statements informed about the nature of event as well as the fact that no provision is necessary.

(b) Verification of Inventories – Auditors’ Duties: The audit procedures to be performed by an auditor to obtain sufficient appropriate audit evidence in relation to inventories have been recommended in the Guidance Note on Audit of Inventories issued by ICAI. On the basis of his evaluation of the effectiveness of the internal controls, the auditor should carry out appropriate substantive procedures in relation to inventories. These substantive procedures include examination of records, attendance at inventory-taking, examination of valuation and disclosure of inventories, carrying out analytical
procedures, and obtaining confirmations from third parties and representations from the management.

In view of above, an auditor should insist on the company to do physical verification of inventory. Verification must be done at least yearly, if not more frequently within a year. Dispensing with physical verification altogether is unacceptable. It is not enough that the company had installed good control procedures. It must be tested, for example, in case of inventory, physically verifying the same as to see that no discrepancy exists. Pilferage, misappropriation is not the only cause for discrepancies. Inherent product qualities like shrinkage, evaporation, handling loss, etc. may also account for discrepancies. The auditor should require the management to conduct physical verification by or near the year end. If the management does not accept to the auditor's view the auditor may appropriately make modification in his audit report.

Additionally, as per clause (ii) of Para 3 of Companies (Auditor’s Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

Question 21
Under what circumstances change in accounting policies is permissible?

Answer

Change in Accounting Policies: Same accounting policies are adopted for similar events or transactions in each period so as to enable the user to compare the financial statements of an enterprise over a period of time. However, Accounting Standard 5, “Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies” provides that accounting policies can be changed under the following circumstances:

(1) if the adoption of a different accounting policy is required by statute; or
(2) for compliance with an accounting standard; or
(3) if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise. AS 5 also requires any change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by AS 5 should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard. For instance, how an enterprise should deal with intangible items appearing in its balance sheet when it applies AS 26 “Intangible Assets” for the first time.
Question 22

How will you verify/vouch the following:

(a) Inventory lying with Third Party

(b) Purchase of Motor Car

Answer

(a) Inventory Lying With Third Party:
   (i) Obtain confirmations from the third party including the time period and reasons thereof.
   (ii) Evaluate condition of goods and see whether adequate provision has been made.
   (iii) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.
   (iv) Ensure that the goods have been included in the closing inventory though lying with third party.

(b) Purchase of Motor Car:
   (i) Ascertain whether the purchase of car has been properly authenticated.
   (ii) Check invoice of the car dealer to confirm purchase price.
   (iii) Examine registration with Transport Authorities to verify the ownership.
   (iv) Ensure that all expenses relating to purchase of car have been properly capitalized and the same have been disclosed properly in the balance sheet.

Question 23

State the different types of Analytical Review carried out in verification of inventories.

Answer

Analytical Procedures for Verification of Inventories: The auditor can adopt the following analytical procedures to verify the inventory of inventories-

(i) Quantitative reconciliation of opening inventories, purchases, production, sales and closing inventories;
(ii) Comparison of closing inventory quantities and amounts with those of the previous year.
(iii) Comparison of the inventory turnover ratios for the current year with that of the previous year and with industry standards if available.
(iv) Comparison of the closing inventory (Raw materials, closing work-in-progress and finished goods are percentage of total inventories) with the corresponding figures of the previous year.
(v) Comparison of current year gross profit ratio of the previous year.
(vi) Comparison of actual inventory, purchase and sales figures with the budgeted figures if available.

(vii) Comparison of raw-material yield/wastage with previous year figures.

**Question 24**

*How will you verify/vouch the following:*

(a) **Purchase of quoted investment.**

(b) **Discounted bill receivable dishonoured.**

(c) **Amount due to subsidiary companies.**

**Answer**

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

(i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., error cum-dividend/ interest/right/bonus.

(ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.

(iii) Verify the amount paid towards purchase of investments.

(iv) Trace the amount in the cheque book counterfoils and bank statements.

(v) Obtain a schedule of investment from Management for physical verification at the year end.

(vi) Verify the investment certificate to confirm title.

(vii) Confirm compliance with statutory provisions such as 143(1) of the Companies Act, 2013.

(viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

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

(i) Obtain the schedule of discounted bills receivable dishonoured.

(ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.

(iii) Verify the bills receivable returned by the bank along with bank’s advice.

(iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the trade receivable is also debited.
(v) Check that bank commission, if any, charged by the bank has been recovered from the party.

(c) Amounts Due to Subsidiary Companies:

(i) Examine whether the subsidiary company is authorized by its Memorandum of Association to advance the loan to the holding company.

(ii) Verify the interest rate at which the loan has been obtained and particulars of the security that has been furnished for confirming the amount of interest and disclosure of the charge in the Balance Sheet.

(iii) Inspect the documents executed by the holding company which constitute the basis of the loan and the provision in the Memorandum under which the loan has been raised.

(iv) Verify by reference to the Balance Sheet of the subsidiary company that the loan is duly reflected in the Balance Sheet as a loan due from the holding company.

(v) Amounts due to subsidiary companies may be on account of credit purchases at goods or services which should be verified with the relevant documentary evidences.

(vi) Confirm whether the provisions of section 189 of the Companies Act, 2013 (related to maintenance of register of contracts or arrangements), wherever applicable, have been complied with.

(vii) Verify that the loan has been properly reflected in the Balance Sheet as per the requirements of Schedule III to the Companies Act, 2013.

Question 25
As an Auditor, comment on the following situations/statements:

(a) X Ltd. had a major breakdown in its plant in the month of February, 2016. In the month of March, 2016 it entered into an agreement with an engineering firm for the purpose of repairing its plant for a consideration of ₹ 180 lacs. The engineering firm started the repairing work in the month of April, 2016 and completed it in the same month. X Ltd. made the provision for said expenditure on repairs in its books of account for the financial year 2015-16 on the plea that the event of breakdown leading to repair expenditure had taken place in the financial year 2015-16, binding contract for repairs was entered into during the financial year 2015-16 and repair work was also completed before the financial statements were approved by the Board of Directors of the company.

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

(a) **Provisions, Contingent Liabilities and Contingent Assets:** As per AS 29 “Provisions, Contingent Liabilities and Contingent Assets”, a liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. A provision is a liability which can be measured only by using a substantial degree of estimation. In the instant case, the engineering firm, during the financial year 2015-16, did not carry out the repair work and hence no liability has arisen as at 31-03-16 as there was no obligation. Thus, the provision made by X Ltd. for repair work as on 31-03-16 is not correct as there was no obligation.

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

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

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

Further, as per clause (ii) of Para 3 of Companies (Auditor's Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

**Question 26**

As an auditor, comment on the RT Ltd. received ₹ 50 lacs as grant from the State Government towards the part cost of a specific machinery. The company credited the above sum of ₹ 50 lacs as income in its Statement of Profit and Loss for the year. What are your views on the accounting treatment of the above receipt of ₹ 50 lacs?

**Answer**

**Accounting Treatment of Government Grants:** As per AS 12 “Accounting for Government Grants”, accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise
acquire such assets. There are two methods of accounting. Under one method, the grant is shown as a deduction from the gross value of the assets concerned in arriving at its book value. Depreciation is charged on reduced value of fixed assets. Under other method, grants related to depreciable assets are treated as deferred income which is recognized in the Statement of Profit & Loss on a systematic and rational basis over the useful life of the assets.

In the given question, accounting treatment of grant received towards part cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report.

Question 27

Write a short note on “First in First out (FIFO) method”.

Answer

First in First out (FIFO) Method: It is a cost formula used in assigning the cost to inventories which are ordinarily interchangeable. The FIFO formula is based on the assumption that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those which have been most recently purchased or produced. It is not applied where items of inventory are not ordinarily interchangeable.

Question 28

As an auditor, comment on the following:

(a) You are a Principal Auditor of Sri Company Limited which has three branches the accounts of which are subject to audit by qualified branch auditors. One of the branch auditors qualified his report for non-provision of doubtful debts which he considered to be material for the company as a whole. Subsequent to their reporting, but before you could sign the audit report on the accounts of the company as a whole, the management informed you that the debt under the subject-matter of qualification in Branch Auditor’s report had been fully recovered.

(b) A Ltd. is a holding company of B Ltd. B Ltd. is going to start a new project estimated to cost ₹20 crores. For this A Ltd. made an investment of ₹10 crores in the shares of B Ltd. by borrowing the same from financial institution @10% p.a. As on 31st March, 2016, the project was not completed. The Directors of A Ltd. want to capitalize the interest upto 31st March, 2016 on borrowings amounting to ₹1 crore and add it to the cost of investments.

(c) A contractor entered into a contract for building roads for ₹2 crores. After completing 60% of the contract he came to know that the cost of completing the contract would be ₹2.40 crores. The accountant transferred ₹0.24 crores i.e., 60% of total loss of ₹0.40 crores to Statement of Profit and Loss in the current year.

(d) Finished goods costing worth ₹10 lacs were damaged due to floods in July, 2014. These goods were included in the closing inventory as on March 31, 2015 at an estimated
realisable value of ₹ 4 lacs. These goods, ultimately, could be sold for ₹ 3 lacs only in the accounting year 2015-16. The difference of ₹ 1 lac was debited to prior period expenditure in the accounting year 2015-16.

Answer

(a) Qualification in Branch Auditor's Report-Subsequent Events: The Branch auditor had qualified on non-provision of a major debt. After his report but before the issue of report by Principal auditor an event happened which has thrown new light on the facts that existed as on the date of balance sheet date. This is a subsequent event within the meaning of SA 560 “Subsequent Events” i.e. event that had taken place between the date of balance sheet date and the date of signing the audit report. In relation to the cases where the component (i.e. branch) is audited by another auditor, the subsequent event would include events that had taken place between the date of audit report of the component and the date of signing the audit report of the entity as a whole by the principal auditor. On becoming aware of the subsequent events, the auditor should consider whether the accounts had been drawn so as to give effect to the facts of subsequent events. Accordingly, the auditor should omit qualification as the debt is no more doubtful in view of its recovery in full. However, the auditor may check that it has in fact been received by a substantial vouching of the subsequent events which had been considered by him to make himself fully satisfied about his report in the matter.

(b) Capitalisation of Interest on Borrowing Cost: AS 16 “Borrowing Costs” states that borrowing cost that are directly attributable to the acquisition, construction or production of a qualifying asset, should be capitalized as a part of the cost of that asset. Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, e.g. manufacturing plants, power generation facilities etc. that require a substantial period of time to bring them to a saleable condition.

In the given case interest of ₹ 1 crore should not be capitalized because as per AS 16-
(a) Investment of ₹ 10 crores in the shares of B Ltd. by A Ltd. is not a qualifying asset.
(b) Only borrowing cost incurred upto acquisition is allowed to be capitalized which would be nil in the case of investments.

Therefore the intention of company is wrong. As an auditor it should be brought to the knowledge of management and interest of ₹ 1 crore should be shown as expenditure in the Statement of Profit & Loss.

(c) Recognition of Contract Revenue & Expenditure: As per AS 7 “Construction Contracts”, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately irrespective of the stage of completion.
In the given case, the revenue that can be recognized for the contract i.e. ₹ 2 crore and the expected expense on the contract is ₹ 2.4 crores. 60% of the contract has been completed. Therefore as per AS 7 whole amount of expected loss i.e. ₹ 0.40 crores should be recognized as an expense immediately irrespective of the stage of completion of the contract.

Therefore the action of accountant of transferring only ₹ 0.24 crores to the profit & loss a/c is wrong. He must transfer whole ₹ 0.40 crore to profit & loss a/c as an expense.

Auditor must advice the accountant to rectify the same and if he fails to do so he should qualify his report.

(d) Prior Period Items: As per AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", "Prior Period items" are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Prior Period items should be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information become known or the transaction is finally settled.

In the instant case there is no error or omission in prior periods. It is a case of accounting estimates which have changed when the damaged goods have been finally sold.

Thus the difference of ₹ 1 Lac, debited to prior period expenditure in the accounting year 2015-16 is a wrong accounting treatment.

Question 29

How will you verify/vouch the following:

(a) Loss of inventory by theft.
(b) Inventory lying with subcontractor for fabrication.
(c) Sale of empties.
(d) Expenditure for advertisement in newspaper.

Answer

(a) Loss of Inventory by Theft:

(i) The most important evidence for verification will be the First Information Report (FIR) filed with the police for this theft.

(ii) The contents of the FIR will be cross checked with the financial books and inventory records.
(iii) If no FIR is lodged, then deeper analysis will be required including satisfaction of the reasons for not filing FIR.

(iv) The quantity and value of the stolen inventory is not included in the closing inventory will be ensured.

(v) Verify whether such inventory was insured and whether theft claim was lodged with the insurance company.

(b) **Inventory Lying With Sub-Contractors for Fabrication:**

(i) The inventory lying with the sub contractor for processing should be confirmed by the confirmation letter obtained from the sub contractors.

(ii) The necessity of holding inventory by them should be vouched. If the inventory is lying with them for long, the reason for the same should be ascertained. The condition of the inventory should be confirmed by the management.

(iii) The inventory should be valued at cost or net realizable value, whichever is less. The processing charges incurred should be added to the cost. The provision for the liability towards unpaid processing charges should be created.

(iv) The inventory should be disclosed under the head current assets under the sub head inventory.

(v) Adjustment in accounts should be made for any discrepancies between inventory confirmed and inventory sent out as per memorandum records.

(c) **Sale of Empties:** When the empties or containers in which goods necessarily have to be supplied are costly, the manufacturer normally agrees to purchase them back at a reduced price as compared to the one charged for them. Therefore check whether

(i) Separate account of issue and receipt of empties has been prepared.

(ii) In separate maintained a/c check how many empties lies in warehouse and how many are with customers.

(iii) Check how many empties customers may return after the close of the year.

(iv) Check whether proper provision has been made against the contingency of the containers being returned by customers and that for the wear and tear.

(v) Check the amount of sale with entry in cash book.

(vi) See the sold empties are reduced from the inventory.

(vii) If the empties are sold on credit, ask for direct confirmation from purchasing party and confirm the sale.

(d) **Expenditure for Advertisement in Newspaper:**

(i) Vouch the copy of the newspaper sent by the newspaper/ advertisement agency to ensure that advertisement actually appeared in the newspaper.
(ii) See the date of advertisement which appeared in the newspaper should fall in the current accounting year.

(iii) Contents of advertisement should be verified to ascertain that the advertisement was of the entity and was for the business and not of personal nature.

(iv) Ensure the rate charged with the offer received for rates from newspaper and ensure that the size and placement i.e. page is in accordance with the rate charged.

(v) Ensure deduction of TDS and service tax wherever applicable.

(vi) Ensure that it is printed in all issues of the newspaper for which newspaper has charged.

Question 30

Write a short note on “Provisions versus Specific Reserves”.

Answer

Provisions Versus Specific Reserves: Provisions are amounts charged against revenue to provide for depreciation, renewal or diminution in the value of assets or a known liability the amount of which cannot be determined with substantial accuracy or a claim which is disputed. Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit.

On the other hand, a specific reserve is created for some definite purpose out of the profits of the company. The purpose may be anything connected with the business which the Article of Association or, the directors want to be provided for, such as dividend equalization, replacement of fixed assets, expansion of the organization, income-tax liability for future foreign exchange fluctuation etc. Though the concerned amounts are carried under the earmarked heads, these are available for distribution as dividend on the recommendation of directors but subject to the approval of shareholders, since these are created by appropriation of profits. To create any specific reserve, existence of profit is essential. Some of the specific reserves may be required under the contractual obligations or legal compulsion, for example: (i) funds for redemption of debentures and (ii) development rebate reserve.

Thus provisions are amounts set apart to meet specific liabilities. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. While to create any specific reserve, existence of profit is essential.

Question 31

How will you vouch/verify the following:

(a) Advance given to a director of a Company.
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(b) Repayment of amount of foreign loan for purchase of an asset.

(c) Grant received for reimbursement of revenue expenditure.

(d) Deferred Tax Liability.

Answer

(a) Advance Given to a Director of a Company:

(i) Verify articles of association for powers of the company to grant advances to director.

(ii) Verify the compliance of Section 185 of the Companies Act, 2013.

(iii) Check the bank book/cash book entries with vouchers.

(iv) Study the contract /loan agreement, terms, rate of interest and inquire whether they are prejudicial to the interest of the company.

(v) Check the confirmation received from the director for outstanding advances.

(vi) Check interest had been duly charged for the outstanding unless it is an interest free advance.

(vii) The loan or advances made to the directors should be distinctly shown in the balance sheet.

(viii) Check the related party transaction with director is disclosed in notes to the account (as per AS 18).

(b) Repayment of Amount of Foreign Loan for Purchase of an Asset:

(i) Check the loan agreement, rate of interest, terms of security.

(ii) Check the remittances made during the year towards installments of repayments made.

(iii) Check the receipted voucher/account confirmation for the balance of outstanding.

(iv) The year end liability of foreign loan should be translated to the rate of exchange prevalent as on the closing date.

(v) The gain or loss arising on exchange conversion is to be credited or debited to Statement of Profit and Loss in accordance with the Accounting Standard 11.

(vi) Check banker exchange rate chart for correctness of the conversion.

(vii) Check RBI or other agencies’ permission for remittances outside India.

(c) Grant Received for Reimbursement of Revenue Expenditure:

(i) Check the amount of receipt, donor details etc. from relevant voucher.

(ii) Study the terms of grant for its utilization and check whether they had been complied with.
(iii) Check the nature of grant, amounts have been duly disclosed in accounts in accordance with Accounting Standard 12.

(iv) Check the provisions of law, if any, affecting foreign contributions if the grant comes from abroad.

(d) Deferred Tax Liability:

(i) The deferred tax liability is created when there is timing difference which results in deferred tax payable with reduction in current tax to the same extent. For example, when more depreciation amount is claimed in Income tax profits than in accounting profits, the current tax payable will be less with a liability to pay more tax in future. This is called Deferred Tax Liability.

(ii) Check the creation of Deferred Tax Liability and its actual working.

(iii) Check how much Deferred Tax Liability is reversed during the year.

(iv) Check that Deferred Tax Liability is disclosed as relating to depreciation and as relating to others.

(v) Check that the provisions of AS 22 “Accounting for Taxes on Income” have been complied with.

Question 32
As an Auditor, comment on the following:

(a) Sri Limited is a manufacturing company engaged in manufacture of cement. It had three plants already commissioned in its site at Chennai. The company expanded its plant capacity by contracting with a supplier for the purchase and installation of one additional plant. The project was commenced on 1.7.2015 and the new plant commenced commercial operations on 1.1.2016. The new plant was capitalized and shown as Fixed Asset as on 31.3.2016 at cost which included, besides other things, the following:

(i) Contract price of plant and equipment and installation costs.

(ii) Interest due for the period till 31.3.2016 for the term loan taken from scheduled bank for financing the project which is repayable over five years commencing from 1.7.2016.

(iii) Salaries, welfare expenses of the plant engineers of the company for the period from 1.7.2015 to 31.12.2015 who supervised the contract work.

(b) The Investments of ABC Limited includes 5,000 equity shares of ₹100 each in Amudhan Bank Limited. Amudhan Bank Ltd. declared 20% dividend for the year ended 31.3.2015 at its General Meeting held on 30.6.2015. ABC Limited finalised its accounts for the year ended 31.3.2015 on 30.8.2015 and it includes ₹1,00,000 being the amount of dividend received by it from Amudhan Bank Ltd. in its other income subsequent to its Balance Sheet date before approval by the Board of Directors.
(b) AS Limited purchased on 1.4.2015 a machinery from a foreign country at a price of $1,50,000 upon terms of credit that the price should be settled within six months from the date of purchase. The company capitalised the Asset and created Liability for the capital goods converting the foreign currency liability to Indian Rupees at a rate of exchange prevailing as on 1.4.2015. When the company settled the liability on 18.7.2015, it had to incur an additional amount of ₹6,75,000 due to change in foreign exchange rate on the date of settlement. It added this additional amount of exchange variation in the capital cost of the asset and charged depreciation upon the enhanced amount of asset value from 18.7.2015.

Answer

(a) Accounting for Fixed Assets and Borrowing Cost: According to AS 10, the cost of fixed asset includes all expenses for bringing into existence and working condition the asset for its intended purpose. Accordingly all expenses attributable to the construction of fourth cement plant can be added to the cost except those which had been not permitted by the AS.

The cost of purchase, installation of asset is directly related to bringing the asset into the working condition for intended use and hence is correctly capitalized.

According to AS 16 on borrowing cost, the interest expenditure on borrowing can be capitalized till the date of the cessation of construction. The capitalization ceases when substantially all activities of construction are completed. Simply, the interest can be capitalized till the completion of the project and it should not be capitalized after commencement. In the instant case of capitalization of interest, the company is partly right in capitalizing it till 31.12.2015 and is wrong for capitalizing it beyond 31.12.2015 i.e. till 31.3.2016.

The allocation of common overhead is allowed if they are specifically relatable to project. The salary expenditure of plant engineers may be capitalized for the construction period.

Accordingly, the auditor shall qualify his report for the deviation if not adjusted, taking into account the materiality of the impact on accounts.

(b) Dividend Recognition: ABC Limited accounted the dividend income from its investment in Amudhan Bank Limited declared subsequent to its (ABC Limited) balance sheet but before finalization of the accounts.

According to AS 9 on revenue recognition, the dividend income is recognized when the right to receive it occurs viz. the date of declaration.

As such, the date of declaration is the relevant date. The date of declaration being 30.6.2015 falls after the end of the accounting period.

Hence, the company is wrong in accounting an income which does not pertain to the year under reference. This may warrant a qualification in the audit report subject to materiality consideration.
(b) **Effects of Changes in Foreign Exchange Rates**: According to AS 11, the foreign currency transactions should be initially recognized at the exchange rate prevailing on the date of transaction. Accordingly, the asset and liability should be accounted at exchange rate prevailing on the date of purchase.

The monetary items should be reported at the exchange rate prevailing on the close of the accounting period. The liability for capital goods purchased is a monetary item.

If during the accounting period, if a monetary liability is settled at a rate different from the rate at which it was initially recognized the exchange difference should be charged to the Statement of Profit & Loss in the year of settlement.

According to AS 11, hence, it is necessary to write off ₹ 6.75 lakhs being exchange differences at the date of settlement. It cannot be added to the cost of the capital. Hence, the company is wrong in capitalizing foreign exchange differences between the amounts of initial recognition and settlement and computing depreciation on the wrongly capitalized portion of the asset.

This warrants correction by the company. Else, the auditor may qualify his report upon relevant considerations.

**Question 33**

As an Auditor, enunciate the General principles of verification of Assets.

**Answer**

**General Principles of Verification of Assets**: It is not sufficient for the auditors only to verify correctness of the amount of assets shown in the balance sheet, he must verify them by actual inspection or otherwise and establish the existence of assets.

Points requiring auditor’s attention for verification are as under:

(i) **Cost** - In regard to assets, verification procedure need not generally be extended to determination of the correctness of costs and authority to incur costs unless the items concerned were purchased during the accounting period under review. In such cases the auditor should check the correctness of costs through normal vouching method. He should ensure that adequate distinction has been made between ‘revenue’ and ‘capital’ nature of costs.

(ii) **Ownership** - Where ownership of assets is evidenced by documents of title etc. as in the case of immovable property, a reference should be made to such documents. If the documents are held by third person the auditor should either obtain a certificate directly from that party or arrange to inspect them at the third party’s place of business.

(iii) **Valuation** - It must be ascertained that all assets are valued in accordance with appropriate accounting policy. For the valuation made, the basis must be consistently applied, unless circumstances necessitated a change. Even then a disclosure is required for the change and its monetary effect.
(iv) **Existence** - Physical inspection should be done wherever possible. Where physical inspection is not possible, the possibility of obtaining indirect evidence be considered e.g. machinery imported held in customs godown or materials sent to subcontractor for job work or fabrication. In such circumstances certificating of such parties should be obtained and if considered necessary even physical verification may be requested.

(v) **Presentation in accounts** - Material assets must be properly disclosed and correctly described in the accounts. It should be seen that the description given to them is clear and complete and is not misleading e.g. stating loans on the assets side of the balance sheet “as dependent upon realization” is just misleading as was held in the case of London and General Bank Ltd. care must be taken to see that disclosures required under the statute or statement issued by ICAI are complied with.

**Question 34**

As an Auditor, comment on the following:

(a) **Lehar Ltd.** installed a new water treatment plant at its factory on 1.10.2015. The company estimated that the new plant will become obsolete after 4 years only and hence charged depreciation at a rate higher than that envisaged in Schedule II to the Companies Act, 2013. During the year 2015-16, the company therefore had written off 1/4 th of the cost.

(b) **Fire Ltd.** purchased equipment for its power plant from Urja Ltd. during the year 2014-15 at a cost of `100 lacs. Out of this they paid only 90% and balance 10% was to be paid after one year on satisfactory performance of the equipment. During the Financial year 2015-16, Urja Ltd. waived off the balance 10% amount which was credited to Statement of Profit and Loss by Fire Ltd. as discount received.

**Answer**

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

(i) Historical Cost.

(ii) Expected useful life of the asset.

(iii) Estimated residual value of the asset.

If the management’s estimate of the useful life of an asset in different than that envisaged under the relevant statute (Schedule II to the Companies Act, 2013), justification for the difference shall be disclosed in its financial statement.

Hence, in the instance case, decision of Lehar Ltd., to write off the cost of water treatment plant over four years is absolutely correct as per AS-6, subject to justification. However, the company has wrongly charged full year’s depreciation during 2015-16 as per requirement of statute. The auditor should highlight this to the company and ask to rectify the same.
(b) **Change in Price of Fixed Assets:** According to AS 10 on Accounting for Fixed Assets, the cost of an asset may undergo changes subsequent to its acquisition on account of exchange fluctuation, price adjustment, changes in duty or similar factors. Such changes in price/cost needs to be adjusted with the cost of the asset.

In the given case, Fire Ltd. initially accounted for 100% amount i.e., ₹ 100 lacs as cost of fixed asset although they paid only ₹ 90 lacs and kept ₹ 10 lacs as payable to the credit of Urja Ltd. Now since the supplier has waived off the balance amount of ₹ 10 lacs, this should be treated as change in price and needs to be adjusted with the cost of asset as per AS 10.

Therefore, the treatment given by Fire Ltd., in crediting ₹ 10 Lacs as discount to Statement of Profit & Loss is completely wrong and needs to be corrected. It will have effect on depreciation also and needs adjustment.

The auditor should report the matter if suitable changes are not made in the accounts.

**Question 35**

*Distinguish between Reserves and Provisions.*

**Answer**

**Reserves and Provisions:**

(i) Reserve is an appropriation of profit whereas provision is a charge against Profit.

(ii) Reserves are not intended to meet any liability, contingency or diminution in the value of assets. Provisions are made to provide for depreciation, renewal or a known liability or a disputed claim.

(iii) Reserves cannot be created unless there is a profit except revaluation reserve and capital subsidy. Provisions must be created whether or not there is profit.

(iv) Reserves are generally optional except in certain situations – Capital Redemption reserve, Debenture Redemption Reserve, etc. Provisions are not optional and have to be made as per generally accepted accounting principles.

(v) Reserves are shown on the liability side. Provisions for depreciation and provision for doubtful debts are shown as deduction from respective assets. Provision for liability is shown on the liability side.

**Question 36**

*How would you vouch/verify the following:*

(a) *Trade payables.*

(b) *Advances to suppliers.*
Answer

(a) Trade Payables:
   (i) Check the adequacy of cut off procedure to ensure that transactions of next period are not accounted and all transactions of year end are accounted.
   (ii) Check posting in the bought ledger from books of prime entry.
   (iii) Compare the balances in the schedule of trade payables with balances in bought ledger.
   (iv) Compare the balances with the confirmation or statement of account received from trade payables.
   (v) Pay special attention to long outstanding items and enquire about the reason thereof.
   (vi) Verify subsequent payments and reversal entries in the bought ledger of year end entries.
   (vii) See that trade payables are classified and shown in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.

(b) Advances to Suppliers:
   (i) Examine the bought ledgers to ascertain the debit balance of trade payables and trace the corresponding entry to the cash/bank book.
   (ii) Obtain a schedule of advances to suppliers and verify it with balances in bought ledger.
   (iii) Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.
   (iv) Obtain/resort to direct confirmation procedure.
   (v) Ensure proper classification in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.
   (vi) Pay special attention to long outstanding advances and enquire about the reason thereof.

Question 37
How would you vouch/verify the following:
(a) Borrowings from Bank.
(b) Work in progress.
Answer

(a) **Borrowings From a Bank:** Borrowings from a bank may be either in the form of overdraft limits; or short term or medium term or long term loans. The audit procedures which an auditor may adopt are outlined below-

(i) Ensure that balance as per books of the client and the bank statement tally. In case of difference between the two amounts, reconciliation statement prepared by the client should account for reasons.

(ii) Examine whether borrowings from the bank have been duly authorized.

(iii) Examine documents to ensure that statutory requirements, if any, with regards to creation and registration charges have been met.

(iv) Examine the loan agreement and ensure that the terms therein have been duly complied with.

(v) Ascertain the purpose for which loan has been raised and examine whether end use of the funds have been accordingly made.

(b) **Work in Progress:**

(i) Involve a technical expert in verification and valuation of WIP, if necessary.

(ii) Ensure that cost sheets are duly attested by the works manager.

(iii) Test the correctness of the cost sheet by verification quantities, cost of material wages and other charges with reference to the record.

(iv) Verify stage of completion with component of cost involved with underlying records.

(v) Compare the unit cost as shown by the cost sheet with standard cost for any large variations.

(vi) Ensure that the allocation of overhead expenses has been made on reasonable basis and is same as used in earlier period.

(vii) Compare the cost sheet with that of the previous year and if there is any large variation, investigate the reason thereof.

(viii) Ensure that the Work-in-Progress as at Balance Sheet date has been appropriately disclosed in Balance Sheet as per the requirements of Part I of Schedule III to the Companies Act, 2013.

**Question 38**

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

(a) In a company Fixed Assets have been revalued and there has been resulting surplus of ₹ 2,00,000, which is transferred to revaluation reserve. The Company has a Debit balance in Statement of Profit and Loss ₹ 1,20,000 as accumulated brought forward losses. The company has adjusted this loss balance against Revaluation reserve.
(b) The Central Government sanctioned ₹20 lakh as Grant to a Hospital for the purchase of certain equipments and paid ₹10 lakh as advance. The hospital took ₹10 lakh as income in the Statement of Profit and Loss for the year.

**Answer**

(a) **Treatment of Revaluation Reserve of Fixed Assets:** The guidance Note on Treatment of Reserve created on Revaluation of ‘Fixed Assets’ advises that the accumulated losses must not be adjusted against revaluation reserve as it would amount to setting off actual losses against unrealized gains.

In the given problem ₹2 lakhs transferred to revaluation reserve is unrealized gain whereas ₹1.20 lakh being debit balance in P & L A/c is actual accumulated loss. This loss cannot be adjusted from unrealized gain raised as revaluation reserve.

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

1. Grant related to depreciable asset is treated as deferred income, which is recognized as revenue in Statement of Profit & Loss on a systematic and rational basis over the useful life of the asset.

   OR

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

In view of the above, the accounting treatment done by the hospital is not justified. The hospital has treated the grant as revenue item by taking it to the Statement of Profit & Loss and has distorted the Statement of Profit & Loss by treating the capital item as revenue. The audit should accordingly qualify the report.

**Question 39**

Write a short note on “Impairment of Assets”.

**Answer**

**Impairment of Assets:** Besides charging annual depreciation on assets by the reason of normal wear and tear, afflux ion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the assets can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as impairment loss. The treatment of impairment loss is similar to depreciation except the fact that it can be re-instated in future, if the recoverable amount of the asset exceeds the carrying amount. The auditor must ensure that the provisions of AS 28 “Impairment of Assets” are followed.
Question 40

(a) A Limited Company has filed a suit against trade receivable from whom ₹25 lakhs are receivable. A judgement is received from court in favour of the company after the date of Balance Sheet. Discuss auditors' duty in this regard.

(b) While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer.

Answer

(a) **Subsequent Events:**

(i) Subsequent events are events occurred after balance sheet date but before the date of audit report.

(ii) In case of audit of components, such as branch or division the subsequent events are events after the balance sheet date and before the date of audit report of that component.

(iii) The subsequent events, according to AS 4 and as reproduced in SA 560 are of two types – (a) those which provide further evidence of conditions that existed at the balance sheet date and (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

(iv) Depending upon the type of subsequent events, the auditor should decide on adjustment of accounts based on evidential value gathered for conditions that existed as on the date of balance sheet date or disclosure of the conditions that arose subsequent to the date of balance sheet.

(v) The auditor should perform audit procedures to identify the subsequent events that are relevant for adjustment/disclosure. These procedures would include reading minutes of Board subsequent to accounting period, contacting lawyers for knowing progress of pending Cases, inquiry with the company management, scrutinizing subsequent interim accounts etc.

(vi) The auditor should perform these procedures as near as practicable to the date of his audit report.

(vii) If the management does not account for the subsequent events in the financial statements where they are to be accounted, the auditor should appropriately comment his report by a qualification or disclaimer.

(b) **Using the Work of Management's Expert:** The Auditor while considering advances granted by bank for purchase of machinery has to consider valuation report given by civil engineer to the bank.

SA 500 “Audit Evidence” clearly states that when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall,
to the extent necessary, having regard to the significance of that expert’s work for the auditor’s purposes,

(i) Evaluate the competence, capabilities and objectivity of that expert;
(ii) Obtain an understanding of the work of that expert; and
(iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

If auditor finds that civil engineer cannot be considered expert for valuation of machinery, he should insert on other analytical procedures to confirm value of machinery. Even after this, if he is not satisfied, he should give qualified opinion.

Question 41
*How would you vouch/verify- Goods lying with third party?*

**Answer**

*Goods Lying With Third Party:*

(i) The auditor should check that the materiality of the item under this caption included in inventories.

(ii) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(iii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iv) The goods lying with them for the very long period would merit auditors’ special attention for making provision.

(v) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(vi) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vii) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(viii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

**Question 42**

*Write a short note on “Physical attendance by auditor during inventory taking”.*
Answer

Attendance at Inventory Taking: According to SA 501 “Audit Evidence- Specific Considerations for Selected Items”, management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

Attendance at physical inventory counting involves-

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor’s risk assessment, planned approach and the specific procedures carried out.

Observing the performance of management's count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management’s instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

Performing test counts, for example by tracing items selected from management’s count records to the physical inventory and tracing items selected from the physical inventory to management’s count records, provides audit evidence about the completeness and the accuracy of those records.

In addition to recording the auditor’s test counts, obtaining copies of management’s completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity’s final inventory records accurately reflect actual inventory count results.

Question 43

State the information to be disclosed in the financial statements according to the requirements of AS 6.

Answer

Requirements of AS 6: AS 6 “Depreciation Accounting” requires following information to be disclosed in the financial statements-
Verification of Assets and Liabilities

(i) Historical cost or other amount substituted for historical cost of each class of depreciable asset;

(ii) Total depreciation for the period for each class of assets.

(iii) The related accumulated depreciation.

It also requires following disclosure of information in the financial statements along with the disclosure of other accounting policies:

(i) Depreciation method used, and

(ii) Depreciation rates or the useful life of the assets, if any, if they are different from the principal rates specified in the statute governing the enterprise.

Question 44

As an auditor, comment on the MNR Co. Ltd. did not provide for depreciation during the financial year 2014-15 due to inadequacy of profits. The company declared dividend during the financial year 2015-16 without providing for the previous year’s depreciation.

Answer

Payment of Dividend Without Providing for Arrears of Depreciation: Section 123(1) of the Companies Act, 2013, prescribes that if a company has not made provision for depreciation for any previous financial year, it should provide for such depreciation before declaring dividend:

(i) Either out of the profits of that financial year, or

(ii) Out of the profits of any other previous years.

In the present case, it would be necessary to make provisions for depreciation in respect of 2014-15 and 2015-16 in the first instance and the balance of profit after providing depreciation including the previous year, could be used for distribution as dividend. Since the company has contravened the provisions of Section 123(1), the auditor should qualify his audit report.

Question 45

How would you vouch/verify “Leasehold property”?

Answer

Lease Hold Property: Following are the main steps involved in verification/vouching of lease hold property-

(i) Inspect the lease agreement to ascertain the amount of premium, if any, for securing the lease and terms and conditions. A lease exceeding the period of one year is not valid unless it has been registered by an instrument. Hence this has to be ensured.

(ii) Ascertain that all the conditions, the failure of which may result in cancellation of the lease have been complied with, e.g. payment of ground rent, insurance premium, maintenance of lease and property in satisfactory state etc.
(iii) Ensure that due provisions for any claims that might arise under the dilapidation clause on the expiry of the lease have been made. If such provision has not been made, the auditor should draw the client’s attention to it.

(iv) Ensure that the outlay and legal expenses incurred to acquire lease property have been capitalised. The property must be written off in such a way that it completely wipes off the asset at the end of the lease period.

(v) He should ascertain that the clause entitles the lessee to sub let any part of the leased property and ensure its proper compliance.

Question 46
Write a short note on “Verification of credit sales”.

Answer
Verification of the Credit Sales: The credit sales should be verified by reference to copies of invoices issued to customers and, in the process, attention should be paid to the following matters-

(i) that each item of sales relates to the period of account under audit;

(ii) that the goods are those that are normally dealt in by the concern.

(iii) that the sale price has been correctly arrived at and the copy of the requisition slip issued by the Sales Department and the copy of the Dispatch Note showing the date and mode of dispatch of goods are attached with the invoice.

(iv) that the amount of the invoice has been adjusted in an appropriate account; and

(v) that the sale has been authorised by a responsible official and in token thereof he has initialed the invoice; also that any alteration in the invoice has been attested by the same person.

Question 47
What points shall an auditor keep in mind while auditing an account of Bought Ledger having a debit balance?

Answer
Auditing an Account of Bought Ledger: The structure of every account in the Bought Ledger is: opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan.
to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule III to the Act. The maximum account due from the directors or other officers of the company at any time during the year and debts due from companies under the same management should also be disclosed along with the names of companies (Part I, Schedule III to the Companies Act, 2013).

Question 48

What procedure an auditor should adopt to test the authenticity of cash at bank?

Answer

Verification of Cash at Bank: While testing the authenticity of cash at bank, the following areas may be considered by the auditor-

(i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) The auditor should examine the possibility, that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

(vi) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.
(vii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(ix) Where material amounts are held in bank accounts which are blocked, e.g. in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(x) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

Question 49
Mention disclosure requirements of the following in the financial statements (in case of a company):

(a) Trade Receivables.

(b) Bank Balances.

Answer

(a) Disclosure Requirements of Trade Receivables in Financial Statements:

Note 6(P) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Trade Receivables” in notes to accounts as follows:

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

   (1) Secured, considered good;

   (2) Unsecured considered good;

   (3) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(b) Disclosure Requirements for Bank Balance: As per Part I of Schedule III to the Companies Act, 2013, the disclosure of bank balances is under the head “Cash and Cash Equivalents” in Current Assets as:

(i) Balances with Banks.
(ii) Earmarked balances with banks (for example, for unpaid dividend).
(iii) Balances with banks to the extent held as margin money or security against borrowings, guarantees, other commitments.

Question 50
Write short notes on the following:
(a) Audit of Sale of Investments.
(b) Verification of assets acquired on lease.

Answer

(a) Audit of Sale of Investments:

(i) See that sale of investment has been made on the proper authorisation of Board or other competent authority.

(ii) Ascertain the method of selling investments. It may be either through broker, directly or through a bank. See the broker’s sold note.

(iii) See that the difference between the carrying amount and the sales proceeds, net of expenses, is recognised in the Statement of Profit & Loss. Ensure that when only a part of the holding of an individual investment is sold, the carrying amount is allocated on the basis of average carrying amount of the total holding of the investments.

(iv) See that proper disclosures as required by AS 13 are made as follows:

1. Interest, dividends, rentals on investments are to be shown in Statement of Profit and Loss at Gross Value and TDS as advance tax paid.
2. Showing separately profit & Loss on disposal and changes in carrying amount of current and long term investments.

(b) Verification of Assets Acquired on Lease:

(i) Examine the terms and conditions of the lease deed.

(ii) If a part of the leasehold property has been sublet, examine the tenant’s agreement.

(iii) Verify relevant document to check the cost of property.
(1) In case of acquisition of an asset is on operating lease, lease payment should be recognized as an expense in the Statement of Profit and Loss on a straight line basis over the lease term;

(2) In case of acquisition of an asset is on finance lease, ensure all the substantial risks and rewards to ownership are transferred, considering the indication as prescribed in AS-19, the lessee should recognize the lease as an asset and as a liability. Such recognition should be at an amount equal to the fair value of the leased assets at the inception of the lease. Ensure contingent rents are recognized as expense in the statement of profit & loss for the period in case of Finance lease.

(iv) Ensure assets acquired under finance lease are segregated from the assets owned.

(v) Ensure that the assets under lease have been properly disclosed as per requirement of Schedule III to the Companies Act, 2013.

Question 51

*What are the factors that are to be considered while designing a confirmation request?*

**Answer**

**Factors to be Considered While Designing Confirmation Request:** As per SA-505 “External Confirmations”, the design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses. The following factors should be considered while designing a confirmation request:

(i) The assertions being addressed.

(ii) Specific identified risks of material misstatement, including fraud risks.

(iii) The layout and presentation of the confirmation request.

(iv) Prior experience on the audit or similar engagements.

(v) The method of communication.

(vi) Management’s authorisation to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management’s authorisation.

(vii) The ability of the confirming party to provide the requested information.

**Question 52**

*You are the auditor and examining the book debts of a company. Give some indications which lead to doubt about recovery as uncollectable debts from trade receivables and advances.***

**Answer**

**Indications of Doubtful and Uncollectible Debts:** The term ‘book debts’ suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range
of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

The following are some of the indications of doubtful and uncollectible debts, loans and advances:

(i) The terms of credit have been repeatedly ignored.
(ii) There is stagnation or lack of healthy turnover in the account.
(iii) Payments are being received but the balance is continuously increasing.
(iv) Payments though being received regularly, are quite small in relation to the total outstanding balance.
(v) An old bill has been partly paid (or not paid), while later bills have been fully settled.
(vi) The cheques received from the trade receivables have been repeatedly dishonoured.
(vii) The debt is under litigation, arbitration, or dispute.
(viii) The auditor becomes aware of unwillingness or inability of the trade receivable to pay the dues, e.g., a trade receivable has either become insolvent, or has closed down his business, or is not traceable.
(ix) Amounts due from employees, which have not been repaid on termination of employment.
(x) Collection is barred by statute of limitation.

Question 53

The Finance Manager of Belt Ltd. is of the opinion that before declaration of dividends it would not be necessary to set off the carried forward amount of debit balance in the Statement of Profit and Loss against current revenue profit but the same could be set-off against existing revaluation reserve. Do you agree?

Answer

Adjustment of Carried Forward Losses against Revaluation Reserves: The Guidance Note on “Treatment of Reserve Created on Revaluation of Fixed Assets” recommends that the accumulated losses should not be adjusted against such revaluation reserve, since this would amount to setting of actual losses against unrealised gains. However, in arriving at divisible profits, the provisions of Section 123 of the Companies Act, 2013 read with the Companies (Declaration and payment of Dividend) Rules, 2014 should be kept in view. The carried over amount of loss and depreciation should be set off against current profit before declaration of dividends.

Since, mere revaluation of assets does not result in realised gain, and, thus, as per the sound accounting practice, the accumulated losses should not be adjusted against revaluation reserve because this would amount to setting off actual losses against unrealised gains.
Therefore, if the debit balance in Statement of Profit and Loss is set off against revaluation reserve, and then dividend is declared from out of revenue profits, it would amount to payment of dividend out of capital without making good the amount of loss and depreciation. Such a declaration will be violation of the provisions of Section 123 of the Companies Act, 2013. Hence, the opinion of the finance Manager of Belt Ltd. is not correct.

Question 54

How will you vouch and/or verify the following:

(a) Bank Overdraft.

(b) Patterns, Dies, Loose Tools, etc.

(c) Investment in the Shares and Debentures of Subsidiary.

Answer

(a) Bank Overdraft:

(i) The auditor should ensure that the facility of overdraft is authorised by the Board’s resolution / partner’s resolution.

(ii) Pursue the agreement with the bank and see whether the overdraft is clean or against hypothecation or pledge of company’s property.

(iii) Verify the register of charges and ensure that the charge has been registered with Registrar of Companies.

(iv) Verify the rate of interest and other terms and conditions from the agreement.

(v) Verify the amount of overdraft from the books of accounts and compare it with the passbook.

(vi) If the overdraft is against hypothecation of assets like inventories, a certificate from the bank should be obtained.

(vii) If the overdraft is against hypothecation of assets or pledge of company’s property, see that overdraft is properly shown under ‘secured loans’ and nature of security has been properly disclosed.

(b) Patterns, Dies, Loose Tools, etc.: Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such asset although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused inventory on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum inventory account of dies and patterns is also maintained. In other concerns, the cost of
tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing inventory, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. It should be seen that the inventory does not include any worn out or defective articles the life of which has already run out.

(c) **Investment in Shares and Debentures of Subsidiary:**

(i) The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc.

(ii) All the particulars entered in the schedule should be verified with the relevant account in the General Ledger.

(iii) The auditor should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.

(iv) The provisions contained in Part I of Schedule III to the Companies Act, 2013 requires that the shares held in a subsidiary should be shown separately.

(v) The shares or debentures of a subsidiary are valued at cost.

(vi) If the subsidiary has suffered a loss, then a provision for the proportionate part of the loss should be made in the accounts of the holding company.

**Question 55**

Describe "Analytical Review Procedures" in Audit. Briefly discuss analytical procedures for verification of trade receivables.

**Answer**

**Analytical Review Procedure:** As per SA 520, Analytical Procedure means analysis of financial information through analysis of relationship among financial and non-financial data. It includes comparison of the entity’s financial information with comparable information with prior period, anticipated results of the entity like budgets etc. or expectations of auditor and similar industry information.
Therefore, an analytical review procedure assists the auditor in planning the nature, timing and extent of other audit procedures. It is an auditing procedure based on ratios among accounts and tries to identify significant changes. Analytical review procedures can be used in the consideration of risks and/or as direct tests of balances. When deciding whether to incorporate analytical review procedures into the examination program as substantive tests of balances, the examiner should consider the extent to which the underlying data should be tested.

**Analytical Procedures in case of trade receivables:** Following are the analytical review procedures which may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables-

(i) comparison of closing balances of trade receivables with the corresponding figures for the previous year;

(ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;

(iii) comparison of actual closing balances of trade receivables with the corresponding budgeted figures, if available;

(iv) comparison of current year’s ageing schedule with the corresponding figures for the previous year;

(v) comparison of significant ratios relating to trade receivables with similar ratios for other firms in the same industry, if available;

(vi) comparison of significant ratios relating to trade receivables with the industry norms, if available.

(vii) Check whether there is any change in credit policy of the organization.

(viii) Check the percentage of bad debts of previous years and current year.

(ix) Find the reasons of major variations in the estimated values and actual values.

These are only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of trade receivables. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgment of the auditor.

**Question 56**

**How will you vouch/verify Intangible Assets?**

**Answer**

**Intangible Assets:** The auditor should verify the following points in this regard-

(i) **An intangible asset should be measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any impairment losses.**
(ii) If an item covered does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

(iii) Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a license or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

(iv) In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Statement, judgement is required to assess as to which element is predominant.

(v) As per AS-26, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

(vi) Auditor should also ensure that proper disclosure is made in the financial statements about the carrying amount, amortisation methods, useful lives, etc.

Question 57

Discuss the recognition principles of contingent liability.

Answer

Recognition Principles of Contingent Liability: An enterprise should not recognize the contingent liability but it should be disclosed in financial statement, unless the possibility of an outflow of resource embodying economic benefit is remote. In some cases an enterprise is jointly and severally liable for an obligation in that case, the part of the obligation that is expected to be met by other parties is treated as contingent liability. Contingent liabilities are continuously assessed and if it becomes probable that an outflow of future economic benefit will be required to settle obligation which is previously assessed as contingent liabilities, a provision is recognized.

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. An enterprise should disclose for each class of contingent liability at the balance sheet date:

(i) A brief description of the nature of the contingent liability, where practicable.
(ii) An estimate of the amount as per measurement principle.
(iii) Indication of the uncertainty relating to outflow.
(iv) The possibility of any reimbursement.
Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

Exercise

1. As an auditor, how would you react to the following situations:
   (a) The company entered into “an agreement for sale” to purchase an office space in a commercial complex. The company with the consent of the promoters started operations from the said place upon signing of the said agreement and included under fixed assets, the total consideration payable.
   (b) Included under sundry trade payables was fees payable to the legal counsel for suits filed against the company. The company is not aware of the status of the suits and hence did not want to provide for the same.
   (c) The company due to liquidity crisis sold and leased back the same vehicles from two different leasing companies on the same terms and conditions. In the notes to accounts the company stated “vehicles taken on lease repayable in 36 instalments of ₹ 36,650 each”.
      The company was of the view that since the total monthly instalments payable was disclosed in totality, no qualification was required to be made by the auditor.

2. State your views on the following:
   (a) Events occurring after the Balance Sheet date.
   (b) Verification, valuation and disclosure of fixed assets.

3. How will you vouch and/or verify the following:
   (a) Inventories.
   (b) Sale of assets.

4. State with reasons, how the following items should be allocated to capital and revenue:
   (i) Repairs to building done shortly after purchase.
   (ii) Costs of raising a loan.

5. (a) What are the general considerations for valuation and verification of assets?
   (b) What is Depreciation of Fixed Assets and why is it provided?