QUESTION NO. 1

ACCOUNTING:

Accounting is an art of recording business transactions in a systematic manners in the books of accounts and to propose required financial statements at the end of financial year.

AUDITING:

Whereas the auditing is the examination of books, voucher, and documents by an auditor to satisfy himself that every transaction has been properly recorded and the balance sheet and profit and loss account is properly drawn up so as to exhibit a true and fair view of the state of affairs and the earnings of the particular concern.

DIFFERENCE BETWEEN ACCOUNTING AND AUDITING

Accounting / Account	Auditing / Auditor
(1) Meaning:	
Accounting is an art of interpreting, Measuring and communicating the results of economic activities.	The auditing is the examination and checking of accounting records and financial statements
(2) Qualification for the Post:	
No qualification has been prescribed for an accountant.	It is fixed by the law i.e for companies, the auditor must be a chartered, Accountant within the meaning of Chartered Accountant ordinance 1961 i.e. member of ICAP.
(3) Appointing Authority:	
The management committee is authorized to appoint accountant.	An auditor is appointed by the Owners or Securities and exchange commission of Pakistan (SECP) are authorized to appoint the auditor.
(4) Rights, Duties and Liabilities:	
All are fixed by business management.	These are fixed by companies ordinance 1984.
(5) Management Influence:	
An accountant is under direct pressure of the business management.	An auditor is not under direct pressure of the management.
(6) Principles:	
Accounting Principles are going concern, Accrual, consistency and prudence.	Auditing principles are independence objectivity, full disclosure and materiality.
(7) Extent of Work:	
Accounting is limited to financial information only.	Auditing is related to both financial & non financial information.

(8) Nature of Work:	
Accounting is concerned with current / present data. It is constructive in nature.	Auditing is concerned with past data. It is analytical in nature.
(9) Nature of Job:	
Accountant job is mechanical in nature.	Auditor job is not so mechanical in that sense.
(10) Purpose:	
Its purpose is to show performance and financial position of business.	Its purpose is to verify the true and fair view of financial statements.
(11) Beginning of Work:	
The work of an accountant starts when the work of a book keeper ends.	The work of an auditor starts when the work of an accountants ends.
(12) Completion Time:	
The time period of accounting is usually one year. It takes one year to complete records.	The time period of auditing is usually less than one year. It may be completed with in one year.
(13) Nature of Subject:	
Accounting is the set of principles concept and methods by which transactions are recorded, classified and summarized.	Auditing is concerned with the verification of accounting data with determining the accuracy and reliability of accounting statements.
(14) Legal Status:	
An accountant is an employee of the company and he / she is to obey the order of the company's management.	An auditor is a neutral of the shareholders and he / she is to safeguard the interest of the company as a whole.
(15) Knowledge:	
An accountant must have accounting knowledge.	An auditor must have accounting as well as auditing knowledge.
(16) Remuneration:	
The remuneration or salary is fixed by the management.	The remuneration or audit fee is fixed by the appointing authority.
(17) Report:	
An accountant submits his report to the management.	An auditor submits his report to the owners..
(18) Removal:	
An accountant is removed as and when desired by the management according to business rules and regulation.	An auditor is not removed an d required to work up to next, annual general meeting.

(19) Advice: Accountant has right to give advice on accounting system.	Auditor has no right to give advice on business matters.
(20) History: The history of business and accounting go side by side.	The history of auditing is short as compared to accounting.

QUESTION NO. 2

See Paper 2014 Question No. 6

QUESTION NO. 3

See Paper 2014 Question No. 2

QUESTION NO. 4

(1) Common Points for all Special Audits:

Auditor has to probe into different facts when he conduct audit in different classes of businesses. There are many steps important to be considered for one industry but not advantageous for another industry. For example, audit in manufacturing business requires financial information, which would have no importance in banking business. However some general points can be summed up which are nearly applicable in every type of business:

(2) Efficiency of Internal Control:

First of all, Auditor see the efficiency of internal control before starting an exhaustive audit work in the organization. Auditor is not merely a machine of checking vouchers and records. He is not a detective but a watch-dog so test system, internal audit and other environmental controls of organization. Sample size in test checking always depends on level of reliance on internal control system.

(3) Verification of Cash in Hand:

The liquid position of organization is very important for decision makers so auditor utilizes his professional skills to discover embezzlements of cash. It is the only item, which at no cost can be test checked. Detailed scrutiny of cash takes place by comparing Cash Book items with cash receipt and cash payment vouchers and also confirmations are made from third party. For example cash received from debtors can be verified with his records and auditors can demand statement of accounts from debtors to confirm the amount received. To find any difference in book balance and physical balance, cash should be counted physically on the date of balance sheet.

(4) Verification of Bank Balance:

Often bank balance does not appear in cash book as it is shown in bank statement due to unpresented cheques, uncredited cheques, receipt from customer directly in bank and bank charges directly deducted. Bank reconciliation statement should be checked in this context so that undue discrepancy is found out. He should also check serial numbering of bank vouchers and missing vouchers must be queried with bank and company officials.

(5) Legal Documents of Business:

Auditor should read legal documents of the company in detail. Careful reading of memorandum, articles, prospectus and manuals of company will highlight the remunerations of directors, policies of company, credit limit, rights and duties of directors and managers etc. auditor can posses copies of these legal documents as working papers helpful not only for reporting but also for next audit in the same company.

(6) Comparative Study of Previous Years Balance Sheets:

Overall trend of business and abnormalities in different assets can only be scanned by comprehensive study of previous years audited balance sheets in contrast of this year financial results. Comparison of previous year and current year statement will highlight all the abnormal differences. Usually horizontal and vertical analyses are practiced to watch the trends of financial figures.

(7) Proper Allocation of Capital and Revenue Items:

Accountants wrongly charge capital and revenue items to understate or overstate the business profits, so auditors should check proper allocation of capital and revenue items. Dislocation is an error of principle and very important to detect for opinion on financial statements. Expenses on purchase of assets, initiation of business, extension of business, giving long term benefit and increasing the earning capacity of business are capital in nature so should not be treated as revenue. Similarly receipts from sale of assets, from surrender of right, from substituting source of income are capital receipt so auditor should confirm their existence in balance sheet only.

(8) Adequate Depreciation:

Sometimes profits are under stated to avoid tax or overstated to show more profits and accountants do it by charging more or less depreciation inconsistently without considering the usage of asset. Auditor should see that depreciation is charged on consistent basis. Physical value of asset can help in estimating the amount of depreciation chargeable in profit and loss account.

(9) Apportioning of Mixed Accounts:

It is a generally accepted accounting principle the expense or income should be recorded for a current accounting year even when cash is paid or received for more years. So auditor should check that advance payment or receipt of cash is recorded in balance sheet and no effect in profit and loss account. Outstanding expenses and unearned incomes must be on liability side whereas prepaid expenses and accrued incomes must be placed on asset side. Auditor's duty is to see that outstanding and prepaid items are shown with correct amounts.

(10) Graphs:

Shareholders are interested in profits so auditor is appointed to check overall financial position of the business. Auditors in modern times, draw graphs to see the fluctuations in profits with respect to time. On graph, months of fiscal period should be on X-Axis and profits or turnover on Y-Axis. This measure will show the consistency or deviation in profits for a particular period. Occurrence of fraud is likely to be in a period where there is an unexpected lies or fall in trend line. Such visual displays are very helpful for auditor when he has to apply test checking. Only abnormal periods will be checked in detail and smooth period can be test checked.

(11) Inspection of Wages Sheet:

Wages and salaries would carry many errors and frauds so wages should be carefully checked. After cashbook, wages sheet requires more concentration because frauds often exist in these two subsidiary records. Auditor can point out salary of dummy workers by proper vouching of Cash Book with wages sheet, leave register and appointment letters of employees.

(12) No Access to Ledgers:

Cashiers should not have an access towards ledger. If cashier is all in all in receiving, vouching and posting cash transactions then frauds of same family like teeming, and lading, kitting and short banking will be common. Auditor should see that separate persons are appointed for ledger maintenance and for cash receipt.

(13) Existing of Secret Reserves:

Audit of special organization is an obvious agency work for shareholders so he is responsible to discover any secret reserves maintained by management. Accountants record secret reserves under wrong head like under the head provision of taxation so auditor should be very careful regarding any abnormal figure of balance sheet.

(14) Schedules of Debtors and Creditors:

Amount of debtors and creditor shown in balance sheet often disturb the short-term solvency position of business. Auditor should verify amount of debtors and creditors with schedules or with subsidiary ledgers. Aging report is also helpful in determining bad debts and in finding age of each debt. Concerned debtor or creditor may also be visited to confirm the figures shown in schedule.

(15) Adequate Supporting Evidences:

Entry without substance (supporting evidence) has no recognition in financial terms so auditor is responsible to check that every expense recorded in books has its supporting evidence. List of missing vouchers should be prepared because fraudulent entries often have a link with such missing vouchers.

(16) Schedule of Loans and Overdraft:

Overdraft from bank is the regular practice of every business to keep the cash cycle active. All the working capital loans, overdrafts and guarantees from bank must be confirmed from bank officials. A systematic way is to prepare a list of borrowings with reference to time period and their utilization should be analyzed in concerned accounts. Credit limit should also be confirmed so that borrowing powers are checked with legal documents of the company. Auditor should also take of securities under charge and accounts on which lien in marked.

(17) Valuation of Current Year Balance Sheet:

Balance sheet is a last resort of financial position and it carries effect of all other financial statements so every item requires scrutiny. Balance sheet is a statement containing assets on one side and owner's equity and liabilities on other side. Shareholders' equity should be in accordance of legal documents (capital clause of memorandum). Outsider' funds are placed in balance sheet under the contracts and agreements with banks and other parties. Fixed assets must be shown at depreciated value and current assets are to be recorded under the rule of cost or market price whichever is less.

(18) **Careful Reading of Minute Book:**

The proceeding of directors' meeting carry answers of many queries of auditor. So minute book, containing all the important decision and suggestions of directors and shareholders should carefully be read. Powers of directors, financial policies of organization and other information always come from minute book.

(19) **Inspection of Marketable Securities and Investments:**

Fluctuations in securities are inherent so day-to-day price fluctuation in market should be compared with face value and lesser value should be considered. If abnormal fluctuations are frequent in securities then auditor should see that whether proper provision is made out of profit for investment fluctuation fund.

[SPECIAL POINTS IN THE AUDIT OF TEXTILE COMPANY]

Direct Purchases of Raw Material:

One of the possibilities of procuring raw material is to purchase directly from farmers. In such a case counterfoil of receipts issued to farmers must be checked. Stock quality and quantity should be physically test checked to verify that rates mentioned for bales purchased are of right quality and quantity.

Material from Own Farm:

If company has its own farm to grow cotton then expenditures of farm must be vouched. Auditor should also compare expenses with previous season's expenses to point out abnormal variations.

Quality Test Check:

Auditor should have a surprise visit to see quality of material issued to production. Efficiency of inspection department will decide that how extensive work will perform by auditor regarding production quality. Stock shown in balance sheet must be of same quality as physically placed in storeroom. In this regard, auditor may have an expert's opinion.

Accounting System:

Textile industry is a manufacturing business so inventory control system should be very strong to avoid idle capacity on the plant. Verification is required that only factory ledgers accounts of work in process, material, factory overhead and finished goods are controlled by factory accountant and remaining assets, liabilities and financial accounts are under the supervision of head office accountant. Periodically production records should be reported to head office.

Expenses of Dead Season:

Agricultural based businesses have a limitation of one crop in one season so auditor should check the stock capacity of company to meet the needs of dead season. Some companies sell extra stock to smaller units, income of such kind should also be vouched.

Verify Duties:

Auditor should vouch custom, excise and other duties paid on purchase of raw material or packing material. Records of agents can be verified in this respect. Custom clearing receipts should also vouched with relevant entries.

Stock Verification:

Physical counting of stock is a must to verify book inventory with physical inventory. Often working capital loans are taken against stock so auditor should also see charge of financial institution on such stock.

Railway Siding:

Arrival of raw material in factory warehouse is systematic by laying railway line up to factory gate so that without interruption raw material move. These expenditures of railway siding are heavy in nature so should be placed in balance sheet as deferred cost.

By-products Department:

The waste of cotton can be utilized again in manufacturing of by products, so incomes and expenses of by-product department should also be vouched in the companies where reprocessing was takes placed

Carriage System:

Carriage expenses are the most frequent head in accounting books of textile company. It is paid at the time of purchasing raw material or on the dispatch of finished goods. CIF (Cost, Insurance & Freight) and other terms should be checked to make clear the expenses of insurance, freight etc. and normally carriage expenses are on the part of seller (company).

Export and Import Documents:

Yarn and fabrics are the two products, which earn the revenue for Pakistan in international market. All the export and import documents should be checked if company has some business outside Pakistan. Letter of credit and other sale and purchase agreements will be helpful in finding exact quantity sold, rate per unit and number of shipments to purchaser.

QUESTION NO. 5

Under Sec. 157:

"Report, which is prepared by auditor and forwarded by board of directors to members of company at least 21 days before the date of statutory meeting, is called statutory report."

Time of Statutory Meeting:

[Section 157(1)]

Every company limited by shares and every company limited by guarantee and having a share capital shall, within a period of not less than three months, nor more than six months, from the date at which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called "the statutory meeting".

Time of Report:

[Section 157(2)]

The directors shall, at least twenty-one days before the date on which the meeting is held, forward a report, in this ordinance referred as "the statutory report", to member.

CONTENTS OF STATUTORY REPORT:

[Section 157(3)]

Shares Allotment:

[U/S 157(3)(a)]

The total number of shares allotted, distinguishing shares allotted otherwise than in cash, and stating the consideration for which they have been allotted.

Cash Received:

[U/S 157(3)(b)]

The total amount of cash received by the company in respect of the shares allotted.

Receipt and Payment Account:

[U/S 157(3)(c)]

An abstract of the receipts of the company and of the payments made there out up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made there out, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company showing separately any commission or discount paid or to be paid on the issue or sale of shares or debentures.

[CHECK LIST FOR RECEIPTS AND PAYMENT ACCOUNT]

Receipts	Payments
Share Capital	Registration fee
Debentures	Stamp duty on capital
Share premium	Underwriting Brokerage or Commission
Premium on issue of debentures	Commission for sale of shares to directs
	Cost of printing memorandum and articles
	Cost of printing and advertising prospectus
	Fees paid to legal advisor
	Fees paid to architecture for new site
	Balance

[OTHER INFORMATION]

Particulars of Directors:

[U/S 157(3)(d)]

The names, address and occupations of the directors, chief executive, secretary, auditors and legal advisors of the company and the changes, if any which have occurred since the date of the incorporation;

Modifications of Contracts:

[U/S 157(3)(e)]

The particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification of proposed modification;

Underwriting Contracts:

[U/S 157(3)(f)]

The details of underwriting contracts and extent to which they have not been carried out.

[U/S 157(3)(g)]

Commission or Brokerage:

The particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares to any director, chief executive, secretary or officers etc.

[Section 157(4)]

State Company Affairs Since Incorporation:

The statutory report shall also contain a brief account of the state of the company's affairs since its incorporation and the business plan, including any change or proposed change affecting the interest of shareholders and business prospects of the company.

Authentication of Statutory Report:

Not less than three directors shall certify the statutory report,, one of whom shall be the chief executive of the company, and shall state-

[Section 157(5)]

Auditor's Certificate:

The statutory report shall, so far as it relates to the shares allotted by the company, the cash received in respect of such shares and to the receipts and payments of the company, be accompanied by a certificate of the auditors of the company as to the correctness of such allotment, receipts of cash, receipts and payments.

A SPECIMAN OF AUDITOR'S CERTIFICATE

"We hereby certify as correct so much of the report as relates to the shares allotted by company and to the cash received in respect of such shares and to the receipts and payments of the company."

Signature

[Name(s) of Auditors]

Date...

Place...

Copies of Statutory Report:

[Section 157(6)]

The directors shall, cause at least five copies of the statutory report, certified as aforesaid, to be delivered to the registrar for registration forthwith after sending the report to the members of the company.

Punishment for Default in Conducting Meeting:

[Section 157(11)]

In the event of any default in complying with provisions of any of the preceding sub-sections, the company and every officer of the company who knowingly and willfully authorizes or permits such default shall be liable:

- If the default relate to a listed company, to a fine not less than ten thousand rupees and not exceeding twenty thousand rupees and in the case of a continuing default to further fine not exceeding two thousand rupees for every day after the first during which the default continues; and
- If the default relates to any other company, to a fine not exceeding five thousand rupees and in the case and in the case of a continuing default to further fine not exceeding two hundred rupees for every day after the first during which the default continues.

This section shall not apply to a private company but if any such private company is converted into a company of either of the classes mentioned in sub-section (1), this section shall become applicable thereto and a reference in that sub-section to the date of commencement of business shall construed as a reference to the date of such conversion.

QUESTION NO. 6

LIABILITY TO THIRD PARTY

Meaning:

"Third party means those persons or concerns which have no direct dealing with the auditor but rely upon the statements signed by the auditor".

Explanation:

The auditor is liable to compensate 3rd party against negligence & fraud. The auditor is expert in checking truth & fairness of accounts. The investors, creditors, banks, insurance companies, tax authorities & government can rely on auditor report.

Examples of 3rd Parties:

- Bankers
- Tax Authorities
- Insurance Company
- Supplier
- Investors
- Government

Conditions:

Auditor is liable to pay damages in the following cases:

(a) If auditor knows that others will rely upon his work.

(b) If party has put reliance on auditor report.

(c) If auditor was negligent.

(d) If party has suffered loss.

CASE LAWS

(1) **DERRY VS PEEK (1889):**

It was held that the auditor may be held liable to third party if it is proved that:

(i) **Untrue Statement:** The statement made by the auditor was materially untrue.

(ii) **Known to Auditor:** The auditor knew that the statement was untrue.

(iii) **Intention to Act:** The statement was made with an intention to persuade the third party to act.

(iv) **Acting and Suffering:** The third party did act on that statement and consequently suffered loss.

Example: Overstating prospectus figures resulting in sale of shares.

(2) ULTRAMASES CORPORATING VS. TOUCHE, NIVEN & CO. (1921):

Facts of Case:

Lender advanced money to Fred Stern & Co. by replying on balance sheet, which was certified by auditor of company. That balance sheet showed net wroth with overstated assets and omission of liabilities.

Plaintiff's Plea:

Auditor had furnished round about 32 copies of their report even they were well aware of the fact.

Verdict of Court:

This case was compromised between the parties because auditor may not know that accounts will be used for what purpose. So court realized that it would be quite wrong to shift liability towards auditor in the absence of tangible contract.

QUESTION NO. 7

CRIMINAL LIABILITY

INTRODUCTION:

An auditor may become criminally liable or committing various offenses, during the course of Audit, constitute crime. He may become criminally liable if his report does not comply with the requirements of law and it is proved that the default was knowingly and willfully done.

MEANING:

"The auditor is liable criminally for following the provisions of Companies Ordinance 1984 and other laws".

EXPLANATION:

The auditor may neglect some provisions of Company law. He may be involved in criminal activities. In such cases he liable to shareholders and other people who rely on them. The negligence, fraud and conspiracy are considered criminal offences. The injured party can go to the court against auditors. Court may decide the matter in the following manner:

- There may be imprisonment for a number of years.
- A fine may be imposed on the auditors
- He may be fines and may face imprisonment also.

LEGAL PROVISIONS:

Following are the different provisions the companies Ordinance regarding the criminal liability:

Mis-statement in Prospectus:

[Section 60]

An auditor may be liable to fine up to Rs. 10,000 or with imprisonment for a term, which may extend to 2 years if the prospectus includes any untrue statement.

Known False Statement:

[Section 66]

If the auditor makes a false statement knowingly to induce other persons to invest money in a company offering shares he shall be liable for imprisonment, which may extend to 3 years or with fine which may extend to Rs. 20,000 or with both.

Disqualified Appointment:

[Section 254(6)]

If an auditor who is qualified to be an auditor of the company acts auditor of the company he shall be liable to fine, which may extend to Rs. 5000.

Not Fulfilling the Legal Requirements: **[Section 260(1)]**

If the auditor's report does not comply with certain provisions of the Companies Ordinance, he may be punishable with the fine up to Rs. 2000 or imprisonment up to 6 months.

Intention of Profit: **[Section 260(2)]**

If the auditor's report is made with the intention to profit such auditor or any other person or to put another person to a disadvantage or loss, he shall be further liable for imprisonment for a term, which may extend to 6 months and with fine, which may extend to Rs. 2000/-.

Assist Inspector: **[Section 268]**

An auditor may be punished up to 2 year and fine up to Rs. 10,000 if he may fail to give to the inspector all assistance in connection with investigation that he is reasonably able to give.

Audited Accounts: **[Section 384(4)]**

An auditor may be liable to a fine up to Rs. 5,000if the auditor shall not submit his report within 2 months of the end of the period to which accounts relate.

Falsification of Books: **[Section 417]**

If auditor in case of a company being wound up is held liable criminally for charge of falsifying the books of accounts or for forgery he may be liable for a fine up to Rs. 20,000 or for an imprisonment up to 2 years or with both.

Winding Up:

[Section 49]

The criminal liability of company officer including auditors may be imposed 1 year before or during liquidation of company for criminal offenses like concealing or removing property, concealing or falsifying documents and papers.

CASE LAWS

(1) DUMBELL'S BANKING COMPANY LIMITED (1900):

Facts of Case:

Dumbell Banking Company issued balance sheet in which a loan from London City and Midland bank Ltd., was shown under the head "Cash in hand". The auditor of bank informed management about charge of amount to wrong head but management presented it as it was. Such statements were predicted for correction but not depicted to share holders in report.

Plaintiff's Plea:

A case was filed particularly against the auditors that a concealment of fraud could be treated as assistance to fraud.

Verdict of Court:

The auditors were criminally liable and sent to jail.

(2) REX VS. KYLSANT OR THE ROYAL MAIL STEAM PACKET COMPANY CASE (1931):

Facts of Case:

Company created excessive secret reserves in book under the heading "Taxation Reserve". Such reserves were not shown in the Balance Sheet. Later the company sustained losses, which were converted into profits by utilization secret reserves.

Plaintiff's Plea:

The shareholders were kept in darkness and they were made to believe that the company was running in profit.

Court Decision:

The court observed that auditor had failed to convey the correct information to shareholders. So auditor was held responsible to false report.

QUESTION NO. 8

AUDIT WORKING PAPERS

The collection of documents, important papers certificates etc. With the help of which an auditor completes his work of audit of business are called Audit working paper.

Who is the Owner of Working Papers:

The working papers are the property of an auditor. He has right to held and own these papers for years.

Definitions:

Leo Herbert says about working papers:

> *"Working papers are the records of the information that has been obtained and of the evidence on the audit objectives that have been gathered and analyzed during audit".*

In Simple words:

> *"Working papers are the connecting links between the clients records and the audited accounts".*

Benefits:

The benefits of the working papers are:

⇒ It helps in planning and performance of audit.

⇒ It helps in supervision of audit work

⇒ It helps the auditor by providing evidence of the work performed by the auditor.

OBJECTIVES OF AUDIT WORKING PAPERS

Audit Opinion:

The audit working papers is the basis of audit opinion about business performance. It is reflected in audit report.

Audit Report:

The auditor gets help from audit working papers in preparing audit report. These papers disclose information for preparing report.

Court Cases:

Audit working papers are helpful to protect the rights of auditor in court of Law. The working papers serves as basis of work performed by an auditor.

Decision Making:

The most important task of management is decision making. The audit working papers provide reliable in formation for decision making.

Evaluation:

The audit working papers help managers to evaluate the performance of their subordinates.

Future Plan:

The purpose of audit working papers is to prepare plan for future. The auditor can determine the way of collecting date from future audits.

Internal Control:

Its purpose is to note the effectiveness of internal control system. In case of poor control there is a need of 100 percent checking.

Helpful to Audit Staff:

The audit working papers are helpful to audit staff. They can come to know about their duties.

Location of Lost Data:

They are used to locate the lost data. Incase of loss of data the working papers provide figures to find out the missing figure.

Prepare Record:

Its purpose is to prepare written record as a proof of audit work done. Such record is the property of auditor.

Tax Assessment:

The assessment of income tax is possible through audit working papers. The tax deducted at source is recorded and net liabilities determined.