PAPER – 6 : AUDITING AND ASSURANCE

*Answer **all** questions*

Question 1

State with reasons (in short) whether the following statements are true or false. (Answer any ten): (10 x 2 = 20 Marks)

(i) While auditing the accounts of a company, it is obligatory that the auditor must adopt sampling technique.

(ii) Interim dividend is not a part of dividend.

(iii) A casual vacancy caused by resignation of the auditor can be filled by the Board of Directors.

(iv) The auditor, in the interest of the users, while explaining the nature of his reservation, can describe the work of the expert with his name, in the audit report without obtaining prior consent of the expert.

(v) The auditee firm has no right to compel the auditor to provide copies of the working papers.

(vi) Comptroller and Auditor General of India can be removed by the Prime Minister of India on the recommendation of his Council of Ministers.

(vii) Provisions of Companies (Auditor's Report) order 2003 as amended upto date, apply to clubs, chambers of commerce, research institutes etc, which have been established under Section 25 of the Companies Act, 1956.

(viii) Mr. X, a Chartered Accountant, is an employee of M/s M & N Co., a firm of Chartered Accountants of India. The firm is the Auditors of ABC & Co. Ltd. After auditing the accounts of the Company the Auditor firm allowed Mr. X, their employee, to sign the audit report; which he did.

(ix) The Auditor disagreed with the management with regard to the acceptability of the Accounting Policies and the inadequacy of disclosures in the financial statements and issued a .disclaimer.

(x) Analytical procedures are unable to help the Auditor in determining the nature, timing and extent of other audit procedures at the planning stage.

(xi) A Company which has been unable to negotiate borrowings from its bankers claims that it will be able to continue as a 'going concern'.

(xii) The overall objective of audit changes in Computer Information System (CIS) environment.

Answer

(i) **False:** It is not obligatory that the auditor must adopt sampling technique in auditing the accounts. But he should ensure that the relevant standards on auditing has been followed. It is in the interest of the auditor if he decides to form his opinion on the basis of audit sample using standards and techniques which are widely followed and recognised.

(ii) **False:** The definition of dividend has been amended by the Companies (Amendment) Act, 2000 where the interim dividend has been treated as part of dividend. With an amendment in Section 205, the interim dividend has been brought at par with dividends declared in the normal course.

(iii) **False:** Casual vacancy caused by resignation of an auditor can be filled only in the General Meeting of the company and not by the Board of Directors.

(iv) **False:** As per SA 620, "Using the Work of an Expert", if the auditor, in the interest of the users includes the name of the expert in his audit report, he can do so only after obtaining the prior consent of the expert.

(v) **True:** Working papers are the property of the auditors. Auditee has no right to compel the auditor's firm to provide it with the copies of working papers. However, the auditors may at their discretion make portions of or extracts from their working papers available to the auditee.

(vi) **False:** The Comptroller and Auditor General of India cannot be removed by the Prime Minister of India on the recommendation of his Council of Ministers. He can be removed on the ground of proven misbehaviour or incapacity, when each House of Parliament decides to do so by majority of not less than 2/3 of the members of the house present and voting.

(vii) **False:** Companies (Auditor's Report) Order, 2003 provides that it shall not apply to companies which have been licensed to operate under Section 25 of the Companies Act, 1956 to promote commerce, art, science, religion, charity and which prohibit the payment of any dividends to their members. Such companies include clubs, chambers of commerce, research Institutes etc.

(viii) **False:** An employee Chartered Accountant cannot sign the auditor's report on behalf of the auditing firm. Only a partner in the firm can sign the audit report in compliance with the provisions of Section 229.

(ix) **False:** The auditor is wrong in issuing a disclaimer. If the auditor disagrees with the management in the matters relating to the acceptability of Accounting policies selected and inadequacy of the disclosures in the financial statements, he should issue a qualified report or express an adverse opinion.

(x) **False:** SA 520 "Analytical Procedure" states that application of analytical procedures helps the auditor to find the aspects of the business of which he was unaware and it will also assist him in determining the nature, timing and extent of audit procedures.

(xi) False: In the case of the company which has not been able to negotiate its borrowings with its bankers, there will be a substantial doubt in its ability to continue as a going concern without such financial support.

Alternative Answer – True: If the company is not able to negotiate borrowings from its bankers for reasons like delay/failure in the submission of adequate documents/information or for other reasons other than the company's financial status then the statement is true.

(xii) False: Overall objective of audit does not change in Computer Information System (CIS) environment. But the use of computer changes the processing and storage, retrieval and communication of financial information.

Question 2

Comment on the following situations:

(a) XYZ Ltd. Co. gave a donation of Rs.50,000 each to a Charitable Society running a school and a trust set up for the service of Blind during financial year ending on 31st March, 2009. The average net profits of the company for the last three years were 15 lakhs. (8 Marks)

(b) Mr. X, a shareholder of the company pointed out that:

(i) The goodwill in the Balance Sheet of the company has appeared on same figure during the past three years.

(ii) Premium received on issue of shares prior to the date of balance sheet has been transferred to Profit and Loss account for arriving at the figure of commission payable to the managing director. (6 Marks)

(c) A, B & C Company Ltd. removed its first Auditor before the expiry of his term without obtaining approval of the Central Government. (6 Marks)

Answer

(a) Donation to Charitable Institutions

Section 293 of the Companies Act, 1956 provides that the Board of Directors of a public listed company can contribute with the approval of the company in General Meeting to a charitable organisation and other such organizations not directly related to the business of the company or the welfare of its employees subject to the limit as under:

(i) Rs.50, 000/- or

(ii) 5% of the average net profits of the last three years, whichever is greater.

Facts of the case: The company has given donation of Rs.50,000/- each to the two charitable organisations which amounts to 1,00,000. Assuming that the charitable organisations are not related to the business of the company, the average profits of the last 3 years is Rs. 15 lakhs and the 5% of this works out to Rs. 75,000. Hence the maximum of donation could be Rs.75,000 only.

Conclusion: By paying donations of Rs.1,00,000 which is more than Rs.75,000, the Board has contravened the provisions of Section 293 of the Companies Act, 1956. Hence the auditor should qualify his audit report accordingly.

(b) (i) As per the provisions of AS 26 "Intangible Assets", an intangible assets should be carried in the books at cost loss accumulated amortization and accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a reputable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use according to Para 63 of AS 26. In the given case, the company has not amortized any value of goodwill since past three years. The auditor should have indicated this fact in his report that no amount of goodwill has been written off during the past three years.

(ii) Premium received on issue of shares is capital receipt and should not credited to profit and loss account. As per the provisions of Section 349 of the Companies Act, premium on issue of shares should not be considered in computation of net profit for the purpose of managerial remuneration. The auditor should have qualified the audit report and qualified the amount by which the profit stands inflated.

(c) Removal of first auditor

As per provision of Sub-section (7) of Section 224, an auditor may be removed from his office before the expiry of his term by the company in general meeting after obtaining prior approval of the Central Government in that behalf, except that such approval is not required for the removal of first auditor appointed by the directors under the proviso to sub-section (5) of Section 224. This is a very stringent provision to ensure that any auditor who is inconvenient to the management cannot be removed so easily. This provision goes a long way to ensure independence of auditor.

However, the first auditor appointed by the Board of Directors can be removed by merely passing an ordinarily resolution in General Meeting of the company without the prior approval of the Central Government.

Therefore, the stand taken by the company in removing the services of an auditor is in order.

Question 3

Discuss the basic principles governing an audit. *(10 Marks)*

Answer

3. Basic principles governing an audit

SA 200 "Basic Principals Governing an Audit", describes the basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried. They are described below:

(i) *Integrity objectivity and independence*: An auditor should be honest, sincere, impartial and free from bias. He should be a man of high integrity and objectivity.

(ii) *Confidentiality*: The auditor should respect confidentiality of information acquired during the course of his work and should not disclose the information without the prior permission of the client , unless there is a legal duty to disclose.

(iii) *Skill and competence*: The auditor must acquire adequate training and experience. He should be competent, skillful and keep himself abreast of the latest developments including pronouncements of ICAI on accounting and auditing matters.

(iv) *Work performed by others*: If the auditor delegates some work to others and uses work performed by others including that of an expert, he continues to be responsible for forming and expressing his opinion on the financial information.

(v) *Documentation*: The auditor should document matters which are important in providing evidence to ensure that the audit was carried out in accordance with the basic principles.

(vi) *Planning*: The auditor should plan his work to enable him to conduct the audit in an effective, efficient and timely manner. He should acquire knowledge of client's accounting system, the extent of reliance that could be placed on internal control and coordinate the work to be performed.

(vii) *Audit evidence*: The auditor should obtain sufficient appropriate evidences through the performance of compliance and other substantive procedures to enable him to draw reasonable conclusions to form an opinion on the financial information.

(viii) *Accounting System and Internal Control*: The management is responsible for maintaining an adequate accounting system incorporating various internal controls appropriate to the size and nature of business. He auditor should assure himself that the accounting system is adequate and all the information which should be recorded has been recorded. Internal control system contributes to such assurance.

(ix) *Audit conclusions and reporting*: On the basis of the audit evidence, he should review and assess the audit conclusions. He should ascertain:

(a) As whether accounting policies have been consistently applied;

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

(c) there is adequate disclosure of material matters relevant to the presentation of financial information subject to statutory requirements.

The auditor's report should contain a clear written opinion on the financial information. A clean audit report indicates the auditor's satisfaction in all respects and when a qualified, adverse or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons thereof.

Question 4

(a) Explain concept of materiality and factors which act as guiding factors to this concept.

(6 Marks)

(b) Describe a set of instructions, which an auditor has to give to his client before the start of actual audit. *(4 Marks)*

Answer

(a) Concept of materiality: SA 320 " Materiality in Planning and Performing an Audit", establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements. Financial statements materially affect if such statement is erroneously stated or omitted to be stated there in and economic decision of the users taken on the basis of such information is influenced by such misstatements or omissions.

The auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not.

There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

Factors to be considered for determining materiality

(i) Item of materiality may be determined individually or in aggregate.

(ii) The materiality depends on the regulatory or legal considerations.

(iii) Materiality is not often reckoned with respect to quantitative details above. It has qualitative dimensions as well.

(iv) Even insignificant items in terms of quality may be material in special circumstances.

(v) Sometimes the materiality of an item in terms of quantity is described in law itself. For example, Schedule VI requires disclosure of items of expenditures which are in excess of one percent or Rs.500, whichever is less.

(vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

(b) Following instructions are given by the auditor to the client before the start of audit:

(i) The accounts should be totalled up and trial balance and final accounts be kept ready.

(ii) Vouchers should be serially arranged.

(iii) Schedule of debtors and creditors should be prepared.

(iv) Schedule of outstanding expenses, prepaid expenses and accrued income to be kept ready.

(v) A list of bad and doubtful debts should be prepared.

(vi) Schedule of investments should be prepared.

(vii) Certified list of goods returned to be prepared.

(viii) Statement of permanent capital expenditure to be prepared.

(ix) Schedule of deferred revenue expenditures to be prepared.

(x) Names and addresses of managers and other officers should be kept ready.

Alternative answer

(1) It is the responsibility of the management to prepare the financial statements, to select and consistently apply the appropriate accounting policies

(2) Management is responsible for the maintenance of adequate accounting records and internal controls for safeguarding assets of the company

(3) Unrestricted access to whatever records, documentation and other information required in connection with the audit.

(4) Management's responsibility for making judgements of estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity.

(5) Management's responsibility for preparation of the financial statements as a going concern.

Question 5

(a) What are the six important points that will attract your attention in the case of audit of a Hotel? (5 Marks)

(b) State the information to be disclosed in the financial statements according to the requirements of AS 6. (5 Marks)

Answer

(a) Audit of a hotel

Following important points will attract the attention of the auditor in the case of audit of a Hotel:

(i) *Internal Controls*: In view of the problems of pilfering in any hotel, the importance of internal controls cannot be overstressed. It is the responsibility of the management to introduce controls which will minimise the leakage as far as possible. If the internal control in a hotel is weak then there exist serious problems for the auditor. The hotel must prepare regularly (preferably weekly) its trading accounts for each sale point and undertake detailed scrutiny of the resulting profit percentages to ensure that is within the anticipated percentage. If the variation is above the permissible limit, he has to get the explanation from the concerned persons.

(ii) *Room Sales*: The charge for room sales is posted to guest bills by the receptionist and 1 night auditor. The source of these entries is the guest register and test checks should be carried out to ensure that the correct number of guests is charged for the current period. Difference, if any, should be investigated to ensure that they have been properly authorised.

(iii) *Stocks*: The stocks in the hotels are readily portable and salable such as food and beverages stocks. All movements and transfers of such stocks should be properly documented to exercise control over each individual stored areas and sale points. The auditor should carry out test checks to ensure that all such documentation is accurately processed.

Areas where large quantities are stored should be kept locked by the manager. Unauthorised persons should not be permitted to enter the store area.

(iv) *Fixed Assets*: Accounting policies for fixed aspects are likely to differ. Many hotels account for quasi-fixed assets such as silver cutlery on stock basis. This may lead to confusion between each stock items and similar assets. In these cases, it is important that very detailed definitions of stock items exist and the auditor should carry out tests to ensure that the definitions have been closely followed.

(v) *Casual labour*: The hotel trade operates, to a very large extent, on casual labour. The record maintained of such wage payments is frequently found to be inadequate. Hence the auditor should ensure that proper internal control system exists to ensure that defalcation on this account does not take place.

(vi) *Booking of hotel for special parties*: The auditor should ensure that the adequate and proper records are being maintained for booking of halls and other premises for special parties and receipts from guests are made on the basis of the tariff.

(b) ***Requirements of AS 6*:** AS 6 requires following information to be disclosed in the financial statements:

(i) Historical cost or other amount substituted for historical cost of each class of depreciating 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 polices:

(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 6

(a) State clearly provisions of the Companies Act, 1956 with regard to issue of shares at a discount. (5 Marks)

(b) As an auditor, comment on the following situation: (5 Marks)

MNR Co. Ltd. did not provide for depreciation during the financial year 2007-08 due to inadequacy of profits. The company declared dividend during the financial year 2008-09 without providing for the previous year's depreciation.

Answer

(a) ***Issue of Shares at a Discount*****:** According to Section 79 of the Companies Act, 1956, a company can issue shares at a discount on the following conditions:

(i) The issue should be authorised by an ordinary resolution of the company sanctioned by the Central Government.

(ii) No such issue of shares at discount can be sanctioned by the Central Government in case the maximum rate of discount should exceed 10% unless the Central Government is of the opinion that a higher rate for discount is justified by the special circumstances of the case

(iii) The issue should be made within two months of the sanction by the Central Government and not earlier than one year after the date of commencement of business.

(iv) The issue should be a class already issued by the company.

(v) It is the duty of the auditor to confirm that the conditions given above have been complied with by the company at the time the allotment was made.

(b) Payment of dividend without providing for arrears of depreciation

Section 205 (1) of the Companies Act, 1956, prescribes that if a company has not made provision for depreciation for any previous financial year, it should provide for such depreciation before declaring / paying 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 2007-08 and 2008-09 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 205(1), the auditor should qualify his audit report.

Question 7

(a) Comment on the following situation: (5 x 2 = 10 Marks)

XYZ Co. Ltd. reappointed A and B as their joint auditors in the Annual General Meeting. The AGM authorised the Board for fillup the vacancy on their own in the event of both or either of auditors declined to accept the assignment. The Board passed a resolution to appoint C if any of the auditors declined to accept the assignment.

B declined to accept the assignment and Board of Directors appointed C in place of B as per its resolution.

Note: How would you vouch/verify the following. (Answer anyone) :

(b) Leasehold property.

Or

Goods sent out on Sale or Return Basis.

(c) Bank overdraft.

Answer

(a) Filling up the vacancy of an auditor

In the present case B is one of the joint auditors who was appointed in Annual General Meeting, but declined to accept the appointment. The Board of Directors as per their resolution, appointed C as a joint auditor in his place.

In this case, the vacancy created by B is neither caused by resignation of B nor is it a casual vacancy because B's appointment had not become effective. Hence, appointment of C as joint auditor by the Board is not valid. C can only be appointed as joint shareholders in the General Meeting.

(b) ***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.

OR

Goods sent out on sale or return basis

(i) A record of goods sent out on sale or return basis should be kept in a specially ruled day book. In this book, first memoranda entries are made.

(ii) When the goods are sold, entry is made by debiting the party and crediting the Sales Account.

(iii) The auditor should refer the memoranda record to confirm that on receipt of acceptance from each party, his account is debited and corresponding sales account is credited.

(iv) For the goods in respect of which period of approval has expired are either received back subsequently and customer's accounts debited.

(v) He should ensure that for the stock of goods sent out on approval, the period of approval, in respect of which had not expired till the close the year, are included in closing stock.

(c) Bank Overdraft

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

(ii) Persue 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 stocks, 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 property disclosed.

Question 8

(a) X, a Chartered Accountant was engaged by PQR & Co. Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors, which was accepted by the Company. In the course of audit of the company, the auditor was unable to obtain appropriate sufficient audit evidence regarding receivables. The client requested for a change in the terms of engagement. *(5 x 2 = 10 Marks)*

Offer your comments in this regard.

Note: Write short notes on the following. (Answer anyone):

(b) Cut-off arrangements

Or

Audit risk at the account balance level and at the class of transactions level.

(c) Powers of C & AG in connection with the performance of his duties.

Answer

(a) Change in terms of engagement

1. An auditor who is required to change the engagement which requires lower level of assurance before the completion of engagement should consider the appropriateness of doing so.
2. But when the terms of engagement are changed, both the auditor and the client should agree on the new terms.
3. However, the auditor should not agree to a change in terms where there is no reasonable justification for doing so.
4. In the instant case, the auditor was unable to obtain sufficient evidence regarding receivables. The client requested him for a change in the terms of the agreement to avoid qualified/adverse opinion. Hence there is no reasonable justification for change in the terms of engagement.
5. Thus the auditor should not agree for change in the terms of engagement letter.

(b) Cut-off arrangements

While doing accounting of financial transactions, it is essential that transactions of one period should be separated from those of the ensuing period so that the working results of each period can be correctly ascertained. This type of arrangement is known as "Cut-off arrangement". It essentially forms part of the internal check of the organisation. Accounts other than sales, purchase and stock are not generally affected by the continuity of the business, and therefore, this arrangement is generally applied only to the above mentioned accounts. The auditor has to satisfy himself by examination and test checks that cut-off procedures adequately ensure that:

(i) Goods purchased, where the property in the goods has been passed to the client, are included in the inventories and that the liability has been provided for in case of credit purchases.

(ii) Similarly, goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

OR

Audit risk at the account balance level and at the class of transactions level

Majority of audit procedures are directed to and carried out at the account balance level and the class of transactions level. At these levels, the auditor uses professional judgment to evaluate numerous factors to assess inherent risk:

(i) Financial statement of accounts likely to be susceptible to mismanagement.

(ii) The complexity of underlying transactions which might require the use of the work of an expert.

(iii) The amount of judgment involved in determining account balances.

(iv) Susceptibility of assets to loss or misappropriation.

(v) The completion of unusual and complex transactions, particularly at or near year end.

(c) Powers of Comptroller and Auditor General in connection with the performance of his duties:

(i) To inspect any an office of accounts under the control of the union or a State Government including office responsible for creation of initial or subsidiary accounts.

(ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(iii) To put such questions or make such observations as he may consider necessary to the person in-charge of the office and to call for such information as he may require for preparation of any account or report, which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transaction as he may determine