

THE COMPANY AUDIT - I

BASIC CONCEPTS

Appointment and remuneration of auditors (Section 224)

Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed. However, the first auditors of the Company are appointed by the Board of Directors within one month from the date of incorporation of a company.

The **remuneration** of the auditors of a company—

- (a) in the case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government, as the case may be;
- (aa) in the case of an auditor appointed under section 619 by the Comptroller and Auditor-General of India, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine; and]
- (b) subject to clause (a), shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

Auditor not to be appointed except with the approval of the company by special resolution in certain cases (Section 224A)

In the case of a company in which not less than twenty-five per cent of the subscribed share capital is held, whether singly or in any combination, by a public financial institution or a Government company or Central Government or any State Government, or any financial or other institution established by any Provincial or State Act in which a State Government holds not less than fifty-one per cent of the subscribed share capital, or a nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment at each annual general meeting of an auditor or auditors shall be made by a special resolution.

Qualifications of auditor (Section 226)

A person shall not be qualified for appointment as an auditor of a company (public or private) unless he is a Chartered Accountant within the meaning of the Chartered

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Accountants Act, 1949; provided that a firm whereof all the partners practising in India are qualified for appointment, as aforesaid, may be appointed by its firm name to be the auditors of a company in which case any partner so practising may act in the name of the firm [Section 226(1)]; and

As per the provisions of the Act, the chartered accountants have exclusive authority to act as the auditors. A chartered accountant either in his individual capacity may act as the auditor or a firm may also act as an auditor provided all partners in the said firm are chartered accountants within the meaning of the Chartered Accountants Act, 1949.

Disqualification of Auditors (Section 226)

Following persons are not qualified for appointment as auditors of a company :

- (a) a body corporate;
- (b) an officer or an employee of the company;
- (c) a person who is a partner, or who is in the employment of an officer or employee of the company;
- (d) a person who is indebted to the company for more than Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs. 1000; and
- (e) a person holding any security of that company.
- (f) if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company.

If an auditor, after his appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4), he shall be deemed to have automatically vacated his office.

Section 227 describes powers and duties of auditors.

Powers of Auditors

- (a) Right of access to books, etc.
- (b) Right to require information and explanation from officers
- (c) Right to attend general meeting -.

Duties of Auditors

Sub-sections (1A), (2), (3), (4) and (4A) of section 227 of the Companies Act, 1956 specifies the duties of an auditor of a company in a quite comprehensive manner.

“(1A) Without prejudice to the provisions of sub-section (1), the auditor shall enquire:

- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;
- (b) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;
- (c) where the company is not an investment company within the meaning of section 372 or a banking company, whether, so much of the assets of the company, as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.”

Sub-sections (2) and (3) of section 227 provide that it is the duty of the auditor to report to the members of the company on the accounts examined by him and on every balance sheet and profit and loss account and every other document declared by the Act to be part of, or annexed to, the balance sheet and the profit and loss account, laid before the company in general meeting during the tenure of his office; also that the report shall confirm the position, envisaged in the under mentioned manner in which the requirements are to be met.

(4A) “The Central Government may, by general or special order, direct that, in the case of such class or description of companies as may be specified in the order, that auditor’s report shall also include a statement on such matters as may be specified therein.

Audit Report

Sub-section (2) specifically requires that the auditor should report whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Companies Act, 1956, in the manner so required and that the balance sheet gives a true and fair view of the company’s affairs at the end of financial year and the profit and loss account gives a

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true and fair view of the profit or loss for the financial year.

Sub-section (3) requires that the auditor shall report on the following matters :

- (a) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for his audit.
- (b) Whether in his opinion, proper books of account as required by law have been kept by the company, so far as appears from his examination of those books and proper returns adequate for the
- (c) Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.
- (bb) Whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by section 228(3)(c) and how he has dealt with the same in preparing the auditor's report.
- (d) Whether in his opinion, the balance sheet and the profit and loss account comply with the accounting standards referred to in sub-section (3c) of section 211 of the Companies Act, 1956.
- (e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company. This clause requires the auditor to highlight in thick type or in italics the observation or comments which have any adverse effect on the functioning of the company. It may be noted that neither auditor's observations nor comments have any adverse effect on the functioning of the company. Instead, those observation or comments are about matters which may have an adverse effect on the functioning of the company. The auditor now have to evaluate his qualifications or adverse comments to make judgement as to which of them deal with matters that have an adverse effect on the functioning of the company within the overall context of audit of financial statement of the company.
- (f) whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274."
- [(g) whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid.]

Power of Central Government to direct special audit in certain cases (Section 233A)

Where the Central Government is of the opinion that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial

practices; or that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or that the financial position of any company is such as to endanger its solvency; the Central Government may at any time by order direct that a special audit of the company's accounts

Audit of cost accounts in certain cases (233B)

Where in the opinion of the Central Government it is necessary so to do in relation to any company required under clause (d) of sub-section (1) of section 209 to include in its books of account the particulars referred to therein, the Central Government may, by order, direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order by an auditor

For details refer to the Companies Act, 1956

Question 1

Comment on the following:

- (a) *NM & Co., chartered accountants were appointed as the auditors of a public limited company in their Annual General Meeting. Various co-operative and term lending institutions held 51% of the paid-up share capital of the company.*
- (b) *Mr. L, a chartered accountant in full-time practice, was acting as the statutory auditor of a public limited company, till it was wound up. Mr. L was appointed as the liquidator for purposes of winding up proceedings.*

Answer

(a) Appointment of Auditors

The implication of shareholding of 51% of paid-up capital by various co-operative and term lending institutions is two fold as discussed below:

- I. In terms of Section 224A of the Companies Act, 1956, a company in which not less than 25% of the subscribed share capital is held, whether singly or in any combination, by:
 - (a) a public financial institution or a Government company or the Central Government or any state government; or
 - (b) any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of subscribed share capital; or

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- (c) a nationalised bank or an insurance company carrying on general insurance business,

the appointment or re-appointment of an auditor in the Annual General Meeting shall be made only by passing a special resolution.

In this case, NM & Co. were appointed as auditors of the public limited company where 51% of the paid-up share capital was held by co-operatives and term lending institutions. Presuming that such institutions are covered by the aforesaid criteria, passing a special resolution was necessary. Hence, the appointment of NM & Co., chartered accountants, was null and void provided such institutions are covered by Section 224A.

Section 619 B read with Section 619 of the Companies Act, 1956 requires that a company in which the central government or any state government or any government company or any government corporation hold either singly or jointly not less than 51% of the paid-up share capital, the auditors of such companies are to be appointed by the central government on the advice of the Comptroller and Auditor General of India.

However, the co-operative and term lending institutions are not covered within the definition of corporation/institution owned by the Central/State Government. Accordingly, the provisions of Section 619 will not apply in this case, although the co-operatives and term lending institutions hold majority share capital.

(b) Appointment of auditor as a liquidator

Regulation 191 of the Chartered Accountants Regulations, 1988 allows a chartered accountant in practice, subject to the control of the Council, to act as a liquidator. But a chartered accountant at the same time cannot act both as liquidator and auditor of the company.

The Institute of Chartered Accountants of India, in order to establish a healthy convention, recommended that in cases where a chartered accountant acts as a liquidator, the statement of accounts to be filed u/s 551(1) of the Companies Act, 1956 should be audited by a qualified chartered accountant other than the chartered accountant who is the liquidator of the company.

The appointment of Mr L, chartered accountant, to carry out both the functions as a liquidator and as an auditor will not be proper having regard to the concept of auditor's independence. Thus Mr L, chartered accountant, cannot act both as the liquidator and the auditor.

Question 2

As an auditor comment on the following situation:

A company had a branch office, which recorded a turnover of Rs.1,99,000 in the earlier year. The auditor's report of the earlier year had no reference regarding the branch although, the branch audit had not been carried out by the statutory auditor.

Answer

Reference to branch audit in the audit report: Under Section 228(4) of the Companies Act, 1956, the Central Government has formulated Companies (Branch Audit Exemption) Rules, 1961 to exempt any branch office of a company from being audited having regard to quantum of activity.

These Rules require that, if during the said financial year, the average quantum of activity of the branch does not exceed Rs.2 lakhs or 2% of the average of total turnover and the earnings from other sources of the company as a whole, whichever is higher, the said branch is exempted.

In the case under review, the turnover is below Rs. 2 lakhs and other information has not been furnished. Accordingly, it may be presumed, exemption may have been granted but still it is necessary that the fact must be mentioned in the audit report.

Since, reference to branch is called for in the auditor's report even if the same has been exempted by the Central Government, the auditor remains responsible. The auditor has, however, no responsibility in respect of the audit of earlier period accounts.

Question 3

- (a) *An auditor purchased goods worth Rs.1,500 on credit from a company being audited by him. The company allowed him one month's credit, which it normally allowed to all known customers.*
- (b) *An auditor became aware of a matter regarding a company, only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion.*

Answer

- (a) **Purchase of goods on credit by the auditor:** Section 226(3) of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees.

This provision aims to ensure that the auditor is independent and under no financial obligation to the company.

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Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand, he is disqualified for appointment as an auditor of the company.

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

- (b) Section 231 of the Companies Act, 1956 empowers the auditors of a company to attend any general meeting of the company; to receive all the notices and other communications relating to the general meeting, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Where the auditor has reason to believe that the directors concealed deliberately a serious fact from the shareholders which came to his notice after issuance of the audit report, he should exercise this right. Normally speaking, an auditor considers subsequent events only upto the date of issuance of the audit report.

The discovery of a fact after the issuance of the financial statements that existed at the date of the audit report which would have caused the revision of the audit report requires that the auditor may bring this to the notice of shareholders.

Likewise, it may be advisable for the auditor to attend the meeting with a view to bringing to the notice of the shareholders any matter which came to his knowledge subsequent to his signing the report and if it had been known to him at the time of writing his audit report, he would have drawn up the report differently; or where the accounts have been altered after the report was attached to the accounts.

Question 4

'At the AGM of ICI Ltd., Mr X was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry. State, how the new auditor will be appointed by ICI Ltd

Answer

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

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

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

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

- (i) *Section 225(1)*: Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor.
- (ii) *Section 190(2)*: Special notice is to be sent to all members of the company at least 7 days before the date of the AGM.
- (iii) *Section 225(2)*: On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- (iv) *Section 225(3)*: Representation if any, received from the retiring auditor should be sent to the members of the company.
- (v) *Section 224A*: Special resolution as required under this section should be duly passed.
- (vi) *Section 224(1B)*: Before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate is to be obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in Section 224(1B).
- (vii) The incoming auditor should also satisfy himself that the notice provided for under Sections 224 and 225 has been effectively served on the outgoing auditor.

Question 5

Write short notes on the following:

- (a) *Auditor's Lien*
- (b) *Disclaimer of Opinion*

Answer

- (a) **Auditor's Lien**: In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain

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the property for non-payment of his dues on account of the work done on the property.

On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non payment of fees, for work done on the books and documents.

The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

- (i) Documents retained must belong to the client who owes the money.
- (ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
- (iii) The auditor can retain the documents only if he has done work on the documents assigned to him.
- (iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under Section 209 of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. However, in both the Act, further provisions are thereunder which books of account could be kept at a different place, pursuant to a Board resolution of which notice must be given to Registrar of Companies.

If in a company meeting, Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar of Companies. If in a company meeting, Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar, the auditor may in such circumstances, exercise the right of lien for non-payment of fees.

However, as per Section 209 he must provide reasonable facility for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints.

His working papers being his own property, the question of lien, on them does not arise.

SA 230 issued by ICAI on Audit Documentation also states that, “working papers are the property of the auditor”. The auditor may at his discretion make portions of or extracts from his working papers available to his clients.

Thus, documents prepared by the professional accountant solely for the purpose of carrying out his duties as auditor (whether under statutory provisions or otherwise) belong to the professional accountant.

In the case of *Chantrey Martin and Co. v. Martin*, it was held that the following documents were the property of the auditor: working papers and schedules relating to the audit, draft accounts of the company, and the draft tax computation prepared by an employee of the auditor.

It is also clear that the accountant’s correspondence with his client (letters written by the client to the accountant and copies of the letters written by the accountant to the client) belong to the accountant. In the case of *Chantrey Martin and Co. v. Martin*, it was also held that the correspondence between the accountant and the taxation authorities with regard to the client’s accounts and tax computations was the property of the client since the accountant merely acted as agent of the client.

However, where the accountant communicates with third parties not as an agent, but as a professional man, e.g., as an auditor, the correspondence with third parties would seem to belong to the accountant. According to the statement, where an auditor obtains documents confirming the bank balance or confirming the custody of securities of the client or other similar documents, it is probable that the courts would hold that these documents belong to the auditor.

- (b) **Disclaimer of Opinion:** Where an auditor fails to obtain sufficient information to warrant an expression of opinion, and, thus, is unable to form an opinion, he issues a disclaimer of opinion.

Accordingly, the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion.

The necessity of a disclaimer of opinion may arise due to many reasons such as the scope of examination is restricted or in certain circumstances the auditor may not have access to all the books of account for certain reasons, e.g., books are seized by excise authorities or destroyed in fire, etc. It is but natural that the auditor must make all efforts to verify and substantiate the events. In case he is unable to obtain audit evidence even from alternative sources, then the auditor can only state that he is unable to form an opinion.

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Question 6

Give your comments and observations on the following:

- (i) *KBC & Co. a firm of Chartered Accountants has three partners, K, B & C; K is also in whole time employment elsewhere. The firm is offered the audit of ABC Ltd. and its twenty branches. The firm already holds audit of 40 companies including audit of one foreign company.*
- (ii) *At the Annual General Meeting of CU Ltd., Mr. L is appointed as the auditor which later is held to be void ab initio. The company holds another general meeting and appoints a new auditor.*
- (iii) *At an Annual General Meeting, Mr. R a retiring auditor claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. P, could not be proceeded with, due to Mr. P's death.*
- (iv) *MNC Ltd. in which 24 per cent of the subscribed capital is held by a public financial institution at the time of issuing the notice for the Annual General Meeting, appoints RK & Co. as auditors by an ordinary resolution at the Annual General Meeting when the Public Financial Institution increased its Stake in MNC Ltd. to 25 per cent of its subscribed capital.*

Answer

- (i) **Ceiling on Number of Company Audits:** According to Section 224(1B) of the Companies Act, 1956 certain chartered accountants cannot hold more than the specified number of company audits. The specified number is to be computed in the following manner:

In the case of firm of chartered accountants, the specified number should be construed as twenty companies (out of which not more than ten may have a paid-up share capital of rupees twenty five lakhs or more) per such partner who is not in whole-time employment elsewhere.

In the firm of KBC & Co., K is in whole-time employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. If B and C do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by KBC & Co., is forty, out of which not more than twenty companies may have a paid-up share capital of rupees twenty five lakhs or more.

Branch audits are not to be counted in computing this specified number. Therefore, it does not matter whether ABC Ltd. is having twenty branches. Audits of the accounts

of foreign companies are also not to be included within the specified number as such companies are outside the scope of section 224.

Thus the acceptance of audit of ABC Ltd. and its twenty branches will accordingly be within specified limits.

(Note: Students may note that section 224(1B) has been amended by the Companies (Amendment) Act, 2000 and a proviso has been added whereby this sub-section is not applicable to a private company after 13.12.2000.)

- (ii) **Observance of provisions of the Companies Act, 1956:** Section 224 of the Companies Act, 1956, lays down the necessary details of appointment of an auditor. Accordingly, it is necessary that requirements of Section 224A with regard to passing of special resolution or ceiling on number of audits as laid down in Section 224(1B) amongst others have to be complied with.

In case a company fails to adhere to statutory provisions laid down in the Companies Act, 1956, then in such cases, the appointment of any person as the auditor at the Annual General Meeting would be void *ab initio*. Under the circumstances in view of the fact that the company failed to appoint an auditor, the provisions of Section 224(3) would be attracted and the appointment of the auditor can be made by the Central Government only.

Accordingly, the appointment of a new auditor at the subsequent general meeting will not be valid.

- (iii) **Reappointment of Retiring Auditor:** Section 224(2) of the Companies Act, 1956 dealing with reappointment of auditors specifies that subject to the provisions of sub-section (1B) and section 224A, at any Annual General Meeting a retiring auditor, by whatsoever authority appointed, shall be re-appointed unless, *inter alia*:

"Where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or dis-qualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with."

However, it should be noted that even for the re-appointment of a retiring auditor, the passing of a resolution is essential. Section 224 of the Companies Act, 1956, requires that a resolution has to be passed by the company every year. In the absence of a resolution, the retiring auditor is not re-appointed automatically.

Thus, the claim of Mr R would not hold good.

- (iv) **Passing of a Special Resolution:** Section 224A of the Companies Act, 1956 does not specify the date on which 25% of the subscribed share capital should be held by

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the specified institutions to require the appointment of the auditors by a special resolution.

The Department of Company Affairs has opined that the material date is the date of the AGM at which the special resolution is required to be passed. In some cases, it is possible that the shareholding of the specified bodies is less than 25% of the subscribed share capital of a company at the time of issuing the notice for the AGM, but exceeds this limit on the date of the AGM. In such a case, it is advisable for the company to adjourn the meeting, issue another notice to the members for appointment of auditors by special resolution and pass the special resolution at the adjourned meeting.

Hence, MNC Ltd. should appoint RK & Co. as auditors in the above mentioned manner.

Question 7

Explain the difference between Clean Audit Report and Qualified Audit Report.

Answer

Clean Audit Report and Qualified Audit Report: A clean report which is otherwise known as unconditional opinion is issued by the auditor when he does not have any reservation with regard to the matters contained in the financial statements. In such a case, the audit report may state that the financial statements give a true and fair view of the state of affairs and profit and loss account for the period. Under the following circumstances an auditor is justified in issuing a clean report:

- (a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
- (b) the financial information complies with relevant regulations and statutory requirements; and
- (c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

Qualified audit report, on the other hand, is one which does not give a clear cut about the truth and fairness of the financial statements but makes certain reservations.

The gravity of such reservations will vary depending upon the circumstances. In majority of cases, items which are the subject matter of qualification are not so material as to affect the truth and fairness of the whole accounts but merely creates uncertainty about a particular item. In such cases, it is possible for the auditors to report that in their opinion but subject to specific qualifications mentioned, the accounts present a true and fair view.

Thus, an auditor may give his particular objection or reservation in the audit report and state "subject to the above, we report that balance sheet shows a true and fair view.....". The auditor must clearly express the nature of qualification in the report. The auditor should also give reasons for qualification. According to 'Statement on Qualifications in Auditor's Report' issued by the ICAI, all qualifications should be contained in the auditor's report.

The words "subject to" are essential to state any qualification. It is also necessary that the auditors should quantify, wherever possible the effect of these qualifications on the financial statements in clear and unambiguous manner if the same is material and state aggregate impact of qualifications.

Thus, it is clear from the above that in case of a clean report, the auditor has no reservation in respect of various matters contained in the financial statements but a qualified report may involve certain matters involving difference of opinion between the auditor and the management.

Question 8

What will be position of the Auditor in the following cases?

- (a) *A, a chartered accountant has been appointed as auditor of Laxman Ltd. In the Annual General Meeting of the company held in September, 2009, which assignment he accepted. Subsequently in January, 2010 he joined B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.*
- (b) *K, a chartered accountant, was appointed as auditor of Y Ltd. In the 12th Annual General Meeting of the company in September, 2008. In June, 2009 the company removed him through a resolution in the general meeting and appointed Ram as its auditor.*
- (c) *Y, is the auditor of X Pvt. Ltd. In which there are four shareholders only, who are also the Directors of the company. On account of bad trade and for reducing the expenses in all directions, the directors asked Y to accept a reduced fee and for that he has been offered not to carry out such full audit as he has done in the past. Y accepted the suggestions of the directors.*
- (d) *While conducting the audit of a limited company for the year ended 31st March, 2010, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.*

Answer

- (a) **Disqualifications of an Auditor:** Section 226(3)(c) of the Companies Act, 1956 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-

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section (5) of Section 226 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) and (4) of Section 226, he shall be deemed to have vacated his office as an auditor. In the present case, A, an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman Limited, has attracted clause (3) (c) of Section 226 and, therefore, he shall be deemed to have vacated office of the auditor of M/s Laxman Limited.

- (b) **Removal of an Auditor:** The removal of auditor K, a chartered accountant, before the expiry of the term of an auditor's appointment by M/s Y Limited is invalid. Sub-section (7) of Section 224 of the Companies Act, 1956 provides that an auditor may be removed from office before the expiry of his term, by the company only in a general meeting after obtaining the prior approval of the Central Government in that behalf.

However such approval is not required for the removal of the first auditor appointed by the Board of Directors under the proviso to sub-section (5) of Section 224. Since prior approval of the Central Government has not been obtained, the removal of K is not valid and, therefore, K continues to be the auditor. The appointment of Ram in his place is void.

- (c) **Restricting Scope of Audit:** Y may agree to temporary reduction in audit fees, if he so wishes, in view of the suggestions made by the directors (perhaps in accordance with the decision of the company taken in general meeting). But his duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders.

There is no concept of full or part audit under Section 227 of the Companies Act, 1956. And, remuneration is a matter of arrangement between the auditor and the shareholders. Section 224(8) specifies the remuneration of an auditor, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

His duties may not necessarily commensurate with his remuneration. Y, therefore, should not accept the suggestions of the directors regarding the scope of the work to be done. Even if Y accepts the suggestions of the directors regarding the scope of work to be done, it would not reduce his responsibility as an auditor under the law. Under the circumstances, Y is violating the provisions of the Companies Act, 1956.

- (d) **Right of Access to Minute Books:** Section 227 of the Companies Act, 1956 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit.

In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.

Question 9

Comment on the following:

- (a) *In case the existing auditor(s) appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy.*
- (b) *Due to the resignation of the existing auditor(s), the Board of directors of X Ltd appointed Mr. Hari as the auditor. Is the appointment of Hari as auditor valid?*
- (c) *At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?*

Answer

- (a) **Board's Powers to Appoint an Auditor:** The appointment of an auditor is complete only on the acceptance of the offer by the auditor. The non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one, the matter would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. The casual vacancy is said to arise only in case of death, resignation, etc. Therefore, the Board is empowered to fill such a vacancy. Section 224(3) of the Companies Act, 1956, empowers the Central Government to fill up a vacancy in case no auditors are appointed or re-appointed at an annual general meeting (AGM). (It is also opined that the appointment of an auditor having been made by shareholders, sub-section (3) cannot be invoked. Thus the auditor could only be appointed by shareholders at general meeting). Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditor (s) appointed at the Annual General Meeting refuse to accept the appointment.
- (b) **Board's Powers to Appoint Auditor(s):** The resignation of the existing auditor(s) would give rise to a casual vacancy. As per Section 224(6) (a) of the Act, casual

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vacancy can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. The rationale behind such a provision is to ensure that resignation is a matter of great concern and, thus, it is necessary that all shareholders must be apprised of reasons connected with resignation in case of a casual vacancy arising on account of resignation. The vacancy shall only be filled by the company in general meeting. Thus the appointment of Mr. Hari as the auditor of the company is not valid.

- (c) **Restrictions on Powers of Statutory Auditors:** Section 227(1) of the Companies Act, 1956 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit. These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence 'any such resolution even if passed by entire body of shareholders is ultra vires and therefore void. In the case of *Newton vs. Birmingham Small Arms Co.*, it was held that any regulations which preclude the auditors from availing themselves of all the information to which they are entitled under the Companies Act, are inconsistent with the Act.

Question 10

- (a) *How would you as an auditor distinguish between Reports and Certificates?*
(b) *State the circumstances when qualified Audit Report is obligatory.*

Answer

- (a) **Distinction between Audit Reports and Certificates:** The term 'certificate', is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. When an auditor certifies a financial statement, it implies that the contents of that statement can be measured and that the auditor has vouchsafed the exactness of the data. The term certificate is, therefore, used where the auditor verifies certain exact facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain precise figures and is in a position to vouch safe their accuracy as per the examination of documents and books of account.

An auditor's report, on the other hand, is an expression of opinion. When we say that an auditor is reporting, we imply that he is expressing an opinion on the financial statements.

The term report implies that the auditor has examined relevant records in accordance with generally accepted auditing standards and that he is expressing an opinion whether or not the financial statements represent a true and fair view of the state of affairs and of the working results of an enterprise. Since an auditor cannot guarantee that the figures in the balance sheet and profit and loss account are absolutely precise, he cannot certify them. This is primarily because the accounts itself are product of observance of several accounting policies, the selection of which may vary from one professional to another and, thus, he can only have an overall view of the accounts through normal audit procedures. Therefore, the term certificate cannot be used in connection with these, statements.

Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

- (b) **Qualified Audit report:** Qualified audit report is one in which the auditor does not give clean report about the truthfulness and fairness of financial statement but makes certain reservations. While qualifying the audit report, it has to be seen that the subject matter of qualification is material but not so much as to affect the overall true and fair view of accounts. Where an auditor fails to obtain sufficient information to warrant an expression of opinion, then he is unable to form an opinion and, thus, he makes a disclaimer of opinion.

Accordingly, the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion. The necessity of a disclaimer of opinion may arise due to many reasons such as restriction on scope of examination or in certain circumstances the auditor may not have access to all the books of account for certain reasons, e.g., books are seized by excise authorities or destroyed in fire, etc. It is but natural that the auditor must make all efforts to verify and substantiate the events. In case he is unable to obtain audit evidence even from alternative sources', then the auditor can only state that he is unable to form an opinion. Therefore, an auditor is required to exercise judgement as to circumstances which may cause modification in the audit report. The following are some of the circumstances when qualified audit report is warranted:

- (a) if the auditor is unable to obtain all the information and explanations which he considers necessary for the purpose of his audit.
- (b) if proper books of account have not been kept by the company in accordance with the law.

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- (c) if the Balance Sheet and Profit and Loss Account are not in agreement with the books of account and returns.
- (d) if information required by law is not furnished.
- (e) if the profit and loss account and balance sheet do not comply, with the accounting standards referred to in sub-section (3c) of Section 211 of the Companies Act, 1956.
- (f) if there is contravention of the provision of the Companies Act, 1956 having a bearing on the accounts and transactions of the company.

The aforesaid circumstances have to be carefully evaluated by the auditor having regard to materiality to see whether the circumstance require disclaimer of opinion or adverse opinion.

The Statement on Qualifications in Auditor's Report apart from giving the circumstances necessitating qualifications in the auditor's report also lays down the principles as to the manner of qualification of the audit report.

Question 11

State with reasons your views on the following:

- (a) *Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2009-2010. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.*
- (b) *Mr. Rajendra, a fellow member of the Institute of Chartered Accountants of India, working as Manager of Shrivastav and Co., a Chartered Accountant firm, signed the audit report of Om Ltd. on behalf of Shrivastav & Co.*

Answer

- (a) **Auditor holding securities of a company** : As per sub-section (3)(e) of Section 226, a person holding any security of the company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000 w.e.f. December 13, 2001 is not qualified for appointment as auditor of that company. For the purpose of this section, "security" means an instrument which carries voting rights.

It is further laid down in sub-section (4) of Section 226 that a person is not eligible for appointment as auditor of any company, if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company. Sub-section (5) of Section 226 provides that if an auditor, after his

appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4), he shall be deemed to have automatically vacated his office.

A firm would also be disqualified to be appointed as an auditor even when one partner is disqualified under clause (e) of sub-section (3) of Section 226.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. As such, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd., which is the holding company of Shiva Ltd., even when one partner is disqualified under this clause.

- (b) **Signature on Audit Report:** Section 229 of the Companies Act, 1956 requires that only a person appointed as the auditor of the company or where a firm is so appointed, a partner in the firm practising in India, may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor. Therefore, Mr. Rajendra, a fellow member of the Institute and a manager of M/s Shrivastav & Co., Chartered Accountants, cannot sign on behalf of the firm in view of the specific requirements of the Companies Act, 1956. If any auditor's report or any document of the company is signed or authenticated otherwise than in conformity with the requirements of Section 229, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document shall, if the default is willful, be punishable with a fine.

Question 12

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

- (a) *The first auditors of Health and Wealth Ltd., a Government company, was appointed by the Board of Directors.*
- (b) *In case the existing auditors reappointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy?*
- (c) *The auditor of Trilok Ltd. did not report on the matters specified in sub-section (1A) of Section 227 of the Companies Act, 1956, as he was satisfied that no comment is required.*
- (d) *At the AGM of a company, in which a Nationalised Bank held 25% of the subscribed capital, Krishna & Co., Chartered Accountants, were appointed as auditor by passing an ordinary resolution.*
- (e) *The members of C. Ltd. preferred a complaint against the auditor stating that he has failed to send the auditors report to them.*

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- (f) *One of the directors of Hitech Ltd. is attracted by the disqualification under Section 274(1)(g).*

Answer

- (a) **Appointment of the First Auditor by the Board of Directors:** Section 224(5) of the Companies Act, 1956 (the Act) lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company”. Thus, the first auditor of a company can be appointed by the Board of Directors within one month from the date of registration of the company. However, in the case of a Government Company, the appointment or re-appointment of auditor is governed by the provisions of Section 619 of the Companies Act, 1956. Hence in the case of M/s Health and Wealth Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.

Thus, the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd., is null and void.

- (b) **Refusal by Auditors to Accept the Reappointment:** Section 224(3) of the Companies Act, 1956 empowers the Central Government to fill a vacancy in case no auditors are appointed or reappointed at an annual general meeting. Since the appointment of an auditor is complete only on the acceptance of the office by the auditor, it can be deemed that in case an auditor refuses to accept the appointment then in that case no auditor has been appointed and the Central Government may appoint a person to fill the vacancy as provided in Section 224(3). Thus, the non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. As a general principle, the shareholders have to exercise this power in all cases, except in the case of filling a casual vacancy or appointing the first auditors. Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditors appointed at the AGM refuse to accept the appointment.

- (c) **Comment on Matters Contained under Section 227(1A) of the Companies Act, 1956:** Section 227(1A) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1A) unless he has any special comments to

make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of Trilok Ltd. is correct in non-reporting on the matters specified in Section 227(1A).

- (d) **Appointment of Auditor by Passing an Ordinary Resolution:** Section 224A of the Companies Act, 1956, provides that in case of a company in which not less than 25% of the subscribed share capital is held whether singly or in any combination, amongst others, by a public financial institution or government company or central or state government or nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment of an auditor or auditors at each annual general meeting shall be made by a special resolution only. In the given case, the nationalised bank held 25% of the subscribed share capital which is equal to the prescribed limit of 25%.

In view of the above provisions, the appointment of Krishna & Co., Chartered Accountants, as auditor of the company is not valid, since as per law, special resolution is required in such circumstances. In such cases, it shall be deemed that no auditor has been appointed and thereupon the Central Government's power to appoint the auditor pursuant to Section 224(3) will become operative.

- (e) **Dispatch of Auditor's Report to Shareholders:** Section 227 of the Companies Act, 1956 lays down the powers and duties of auditor. As per provisions of the law, it is not a part of the auditor's duty to send a copy of his report to members of the company. The auditor's duty concludes once he forwards his report to the company. It is the responsibility of company to send the report to every member of the company. In *Re Allen Graig and Company (London) Ltd.*, 1934 it was held that duty of the auditor after having signed the report to be annexed to a balance sheet is confined only to forwarding his report to the secretary of the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.
- (f) **Disqualification of a Director u/s 274(1)(g) of the Companies Act, 1956:** Section 227(3)(f) as inserted by the Companies (Amendment) Act, 2000 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as directors under Section 274(1)(g) of the Companies Act, 1956. To this end, the auditor has to ensure that written representation have been obtained by the Board from each director that one is not hit by Section 274(1)(g). Since in this case, one of the director is attracted by disqualification u/s 274(g) of the Act, the auditor shall state in his report u/s 227 about the disqualification of the particular director.

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Question 13

Give your comments on the following:

White Star Ltd. was incorporated on 1.8.2009 and Mr. T who is related to the Chairman of the Company appointed as auditor by the Board of Directors in their meeting on 4.9.2009.

Answer

Appointment of First Auditors by the Board: Apparently, there are two issues arising out of this situation, viz., first one relates to appointment of first auditor by the Board of Directors; and second, pertains to relation of such an auditor with the Chairman of the company. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditors, it may be noted as per the provisions of Section 224(5) of the Companies Act, 1956, the first auditor of a company shall be appointed by the Board of Directors within one month of the date of registration of the company. As per the facts given in the case, the Board has failed to appoint the first auditor within one month of the registration of company because the date of incorporation of White Star Ltd. is 1-8-2009 and the date of appointment of auditors by the Board of Directors is 4-9-2009. Therefore, proviso of Section 224(5) becomes operational. Accordingly if the Board fails to appoint the first auditor, the Blue star Ltd. in general meeting has to make the appointment. Thus the appointment of Mr. T is not valid. Under the circumstances, the second issue relating to relationship of auditor with the Chairman becomes redundant.

Question 14

Draft an illustrative Audit Report u/s 227 of the Companies Act, 1956, with a few qualifications. Annexure u/s 227(4A) is not required.

Answer

An illustrative auditor's report on the financial statements in case of a company under Section 227 of the Companies Act, 1956 to which AS 3 is applicable is given below:

Auditor's Report

The members of M/s X LTD.

1. We have audited the attached balance sheet of M/s X Ltd., as at 31st March, 2XXX and also the profit and loss account and the cash flow statement for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.
2. We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain

reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

3. As required by the Companies (Auditor's Report), Order, 2003 issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure a statement on the matters specified in the paragraphs 4 and 5 of the said Order.
4. As stated in Note X of Schedule to the financial statements, no depreciation has been provided for the period in the financial statements. This is contrary to Accounting Standard (AS) 6 on "Depreciation Accounting", issued by the Institute of Chartered Accountants of India and the accounting policy being followed by the entity according to which depreciation is provided on straight line basis. Had this accounting policy been followed, the provision for depreciation for the period would have been Rs..... This short provisioning for depreciation has resulted into the profit for the year, fixed assets and reserves and surplus being overstated by Rs.....
5. Further to our comments in the Annexure referred to above, we report that:
 - i. We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purpose of our audit.
 - ii. In our opinion, proper books of account as required by law have been kept by the company so far as appears from our examination of those books (and proper returns adequate for the purposes of our audit have been received from the branches not visited by us). The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with.
 - iii. The Balance Sheet and Profit & Loss Account and Cash Flow Statement dealt with by this report are in agreement with the books of accounts (and with the audited returns from the branches).
 - iv. In our opinion, the Balance Sheet, Profit and Loss Account and Cash Flow Statement dealt with by this report comply with the accounting standards referred to in sub-section (3C) of Section 211 of the Companies Act, 1956;
 - v. On the basis of written representations received from the directors, as on 31st March 2XXX and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 2XXX from being

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appointed as a director in terms of clause (g) of sub-section (1) of Section 274 of the Companies Act, 1956;

6. In our opinion and to the best of our information and according to the explanations given to us, subject to the effects on (on the financial statements of the matter referred to in the paragraph 4), the financial statements give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:
- a. in the case of the Balance Sheet of the state of affairs of the company as at 31st March 2XXX;
 - b. in the case of the Profit and Loss Account of the profit/loss for the year ended on that date; and
 - c. in the case of the Cash Flow Statement of the Cash Flow for the year ended on that date.

Place of Signature
Date:

For XYZ and Co.
Chartered Accountants



Signature
(Name of the member signing the Audit Report)
Designation
M.NO. _____

Question 15

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

- (a) *AAS Ltd. is procuring the packing materials from M/s XY and Co., a partnership firm consisting of Mr. X and Mr. Y. Mr. Y is the Managing Director of AAS Ltd. The total value of purchases made from XY and Co. by AAS Ltd. during the year 2009-10 had been Rs. 38 lakhs.*
- (b) *X Ltd. is good in profits, but suffers temporarily in liquidity. It proposes to declare dividend of 10% in annual general meeting, but the Board proposes to defer payment of dividend by two months from the date of annual general meeting by getting a resolution passed in AGM*

Answer

- (a) **Transactions with Related Parties:** SA 550 "Related Parties" establish standards on auditor's responsibilities and audit procedures regarding related party transactions. In this case, the related party relationship is absolutely clear and accordingly the

auditor must examine that the disclosure requirements as laid down in AS 18, "Related Party Disclosures" has been followed, as Managing Director. Further, the auditor has to ensure compliance with the CARO, 2003 requirements, viz., transaction required to be entered into the Register pursuant to section 301 of the Companies Act, 1956 and having regard to the fact whether such prices were reasonable or not. Accordingly, the auditor has to ensure that the AAS Ltd. has made proper disclosures in financial statements and the matter has been examined and reported in terms of CARO, 2003 also.

- (b) **Declaration of Dividends:** As per law, dividend once declared cannot be revoked. However, as per facts of the case, X Ltd. has not declared the dividends so far because Board proposed to recommend declaration of 10% dividend in annual general meeting but in view of liquidity problem it proposes to defer the payment of dividend by two months from the date of annual general meeting by getting a resolution passed in AGM. As per the question it is clear that the Board has only made a proposal and the same has not been passed by the shareholders. Therefore, in such a case, X Ltd. may declare dividends at a subsequent general meeting.

Note: Students may note that in case dividend has actually been declared in terms of section 205 (A)(1), the penal and other provisions shall become applicable.

Question 16

- (a) *The auditor of a limited company has given a clean report on the financial statement on the basis of Xerox copies of the books of accounts, Vouchers and other records which were taken away by the Income-tax Department in search under section 132 of the I.T. Act, 1961.*
- (b) *E and S were appointed as Joint Auditors of X and Y Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the notice of both the Auditors.*
- (c) *Aakansha is a member of the Institute of Chartered Accountants of England and Wales. Is she qualified to be appointed as auditor of Indian Companies?*
- (d) *Preksha, a member of the ICAI, does not hold a Certificate of practice. Is her appointment as an auditor valid?*
- (e) *'B' owes Rs. 1001 to 'C' Ltd., of which he is an auditor. Is his appointment valid? Will it make any difference, if the advance is taken for meeting-out travelling expenses?*

Answer

- (a) **Reliability of Audit Evidence:** The degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be

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considerably increased if the xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly.

Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

- (b) **Responsibilities of Joint Auditors:** In conducting a joint audit, the auditor(s) should bear in mind the possibility of existence of any fraud or error or any other irregularities in the accounts under audit. The principles laid down in SA 200A, SA 240 and SA 299 need to be read together for arriving at any conclusion. The principle of joint audit involves that each auditor is entitled to assume that other joint auditor has carried out his part of work properly. However, in this case, if it can be assumed that the joint auditors E and S have exercised reasonable care and skill in auditing the accounts of X & Y Ltd. and yet the concealment of transaction has taken place, both joint auditors cannot be held responsible for professional negligence. However, if such concealment could have been discovered by the exercise of reasonable care and skill, the auditors would be responsible for professional negligence. Therefore, it has to be seen that while dividing the work, the joint auditors have not left any area unattended and exercised reasonable care and skill while doing their work.
- (c) **Qualification for Appointment as an Auditor:** Aakansha, a member of the Institute of Chartered Accountants in England and Wales is not qualified to be appointed as an auditor of a limited company in India, since she is not a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 and hence not a member of the Institute of Chartered Accountants of India. (This is on the presumption that Aakansha has qualified recently from the ICAEW and in the absence of any reciprocity agreement between the two Institutes, as on date, her name is not borne on the Register maintained by the Institute of Chartered Accountants of India). Because as per the Chartered Accountants Act, 1949, a person must be a member of the Institute and holds certificate of practice. However, as it appears from the facts

given in the case, Aakansha is not a member of the Institute of Chartered Accountants of India and, thus, is not qualified to audit companies under the Companies Act, 1956.

- (d) **Qualifications of an Auditor:** A person shall be qualified for appointment as an auditor of a company, only if one is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Under the Chartered Accountants Act, 1949, only a Chartered Accountant holding the certificate of practice can engage in public practice. Preksha does not hold a certificate of practice and hence cannot be appointed as an auditor of a company.
- (e) **Indebtedness to the Company:** As per Section 226(3)(d) of the Companies Act, 1956, a person who is indebted to the company for an amount exceeding Rs.1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs.1000/- then he is not qualified for appointment as an auditor of a company. Accordingly, B's appointment is not valid and he is disqualified as the amount of debt exceeds Rs.1000. Even if the advance was taken for meeting out travelling expenses particularly before commencement of audit work, his appointment is not valid because in such a case also the auditor shall be indebted to the company. The auditor is entitled to recover fees on a progressive basis only.

Question 17

Explain the various types of companies under Companies (Auditor's Report) Order, 2003 (CARO).

Answer

Types of Companies under CARO, 2003: CARO, 2003 applies to all companies including a foreign company as defined u/s 591 of the Companies Act, 1956.

The Order specifically exempts banking companies, insurance companies and companies which have been licensed to operate u/s 25 of the Act. The order also exempts from its application a private limited company which fulfils certain conditions.

The CARO also contains definition of companies engaged in different kinds of activities, viz., manufacturing, mining, chit fund, etc. For instance, it defines manufacturing company as a company engaged in any manufacturing process as defined in the Factories Act, 1948; finance company as a company engaged in the business of financing, whether by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing; investment company as a company engaged in the business of acquisition and

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holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central or any State Government or by any local authority, or in other marketable securities of a like nature, etc.

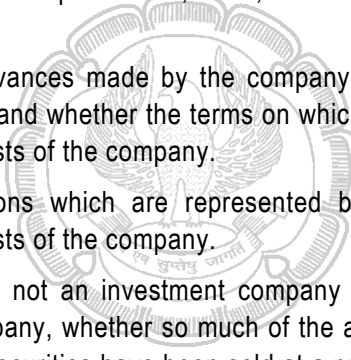
(Note: As per the Amendments made by the Companies (Auditor's Report) (Amendment) Order, 2004 in the Companies (Auditor's Report) Order, 2003 the following companies engaged in different kinds of activities, viz., finance company, investment company, manufacturing company, mining company, processing company, service company and trading company (Clause (c) to (i) of Paragraph 2) are omitted).

Question 18

Write a short note on Audit enquiry under Section 227(1A).

Answer

Audit enquiry under Section 227(1A): Auditor is required to make an enquiry and report under Section 227(1A) of the Companies Act, 1956, if he is not satisfied in respect of the following matters:

- 
- (i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company.
 - (ii) Whether the transactions which are represented by mere book entries are not prejudicial to the interests of the company.
 - (iii) Where the company is not an investment company within the meaning of Section 372, or a banking company, whether so much of the assets as consist of shares and debentures and other securities have been sold at a price less than that at which they were purchased by the company.
 - (iv) Whether loans and advances have been shown by way of deposits.
 - (v) Whether the personal expenses have been charged to revenue.
 - (vi) Where it is stated in the books and papers of the company that any shares have been allotted for cash whether the cash has actually been received and if no cash has been received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Question 19

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

- (a) *A Ltd. has its Registered Office at New Delhi. During the current accounting year, it has shifted its Corporate Head Office to Indore though it has retained the Registered*

Office at New Delhi. The Managing Director of the Company wants to shift its books of account to Indore from New Delhi, as he feels that there is no legal bar in doing so.

- (b) *The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts were considered.*

Answer

- (a) **Place of Books of Account:** Section 209 of the Companies Act, 1956 states that every company shall keep at its registered office proper books of account with respect to all sums of money received and spent, all sales and purchases of goods, all assets and liabilities of the company, and the required cost records.

However, all or any of such books of account aforesaid may be kept at any other place in India as the Board of Directors may decide, and if so, the company shall within seven days of the decision file with the Registrar a notice in Form 23 AA in writing giving the full address of that other place.

Therefore, for shifting the books from Delhi to Indore, the Board's Resolution has to be passed, and notice is to be given to the Registrar of Companies within the specified time. The auditor may accordingly, inform the Managing Director that his contention is not in accordance with the legal provisions.

- (b) **Auditor's Attendance at Annual General Meeting:** Section 231 of the Companies Act, 1956 confers right on the auditor to attend the general meeting.

The said section provides that all notices and other communications relating to any general meeting of a company which any member of the company is entitled to have are also to be forwarded to the auditor. Further, it has been provided that the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as an auditor.

Therefore, the section does not cast any duty on the auditor to attend the annual general meeting. The law only confers right on the auditor to receive notices and also attend the meeting if he so desires. Therefore, the complaint filed by the Board of Directors is based on mis-conception of the law.

Question 20

Give your comment on "The Central Government has appointed Mr. Sushil, a retired Finance Director of a reputed company, a non-practising member of ICAI, as a special auditor of MM Ltd., on the ground that the company was not being managed on sound business principles. Mr. Ajay, MD of MM Ltd. feels, that the appointment of Mr. Sushil is not valid as he does not hold a certificate of practice".

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Answer

Appointment of Special Auditor: Section 233A of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted.

Amongst others, one of the circumstances specified is in case a company is not being managed in accordance with some business principles or prudent commercial practices. Further the said section also provides that for the purpose, it may appoint a chartered accountant, whether or not the chartered accountant is in practice, or the company's auditor itself to conduct such special audit.

Therefore, the appointment of Mr. Sushil, a non-practising member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Mr. Ajay M.D. is not correct.

Question 21

Write a short note on - Cost Audit.

Answer

Cost Audit: Cost Audit is covered by Section 233B of the Companies Act, 1956. The Central Government may by order direct that audit of cost accounts of a company shall be conducted in the manner, as may be specified in the order by a cost accountant.

The cost auditor shall be appointed by the Board of Directors of the company with the previous approval of the Central Government before the appointment of the cost auditor by the Board, a written certificate shall be obtained by the Board from the auditor proposed to be appointed to the effect that if the appointment is made, it will be as per Section 224 (IB).

Cost audit shall be in addition to an audit under Section 224. A cost auditor shall have the some powers and duties as that of a statutory auditor, the cost auditor shall make his report to the Central Government in the prescribed form and within the prescribed time.

A copy of the report shall be forwarded to the company. The company shall within 30 days from the date of receipt of a copy of the report furnish the Central Government with full information and explanations on every reservations and qualifications contained in such report.

The Central Government has issued Cost Audit (Report) Rules specifying the form of the report and additional information to be included therein in the form of annexure.

The auditor must further report on the adequacy of cost accounting records mentioned by the company under Section 209(1)(d) of the Act to confirm that they give a true and fair view of the cost of production, processing, manufacturing, or mining activities as the case may be.

Question 22

Give your comments on the following:

The auditors of ABC Ltd. issued a qualified opinion about the truth and fairness of the accounts of the company for the year ended 31.3.2009. They typed out the matters of qualifications in a bold font so as to invite the attention of the readers to them. The Board objected to it and required them to be typed out in the same normal font as other paragraphs of the report appear.

Answer

Qualified Report: Section 227(3)(e) requires that “the observations or comments of the auditors which have any adverse effect on the functioning of the company” should be given in the auditor’s report “in thick type or in italics” so that these are identified readily and clearly by the readers (including regulatory authorities). According to ICAI, this requirement does not in any way extent the scope of audit. It requires the auditor to evaluate his qualifications and make a judgement regarding which of them deal with matters that may have an adverse effect on the functioning of the company. Since auditor is of the view that such qualifications need to be highlighted in bold in conformity with the provisions of the set, the management has no right to object on the same.

Question 23

- (a) *State the matters to be specified in Auditor’s Report in terms of provisions of Section 227(3) of the Companies Act, 1956.*
- (b) *What are the reporting requirements in Companies (Auditor’s Report) Order, 2003 in respect of money raised by public issues?*

Answer

- (a) **Matters to be reported by auditor under section 227 (3):** Under Section 227(3) of the Companies Act, 1956, the report of the auditor shall state -
 - (i) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;
 - (ii) Whether, in his opinion, proper books of accounts as required by law have been kept by the company so far as appears from his examination of those books; whether proper returns adequate for the purposes of his audit have been received from the branches not audited by him;
 - (iii) Whether the report on the accounts of the branches audited by branch auditors under Section 228 has been forwarded to him and how he had dealt with the same in preparing the auditor's report;

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- (iv) Whether the company's balance sheet and profit and loss account are in agreement with the books of accounts and returns;
- (v) Whether in his opinion the profit and loss account and balance sheet comply with the accounting standards referred to in Section 211(3C);
- (vi) In thick type or in italics the observations or comments of auditors which have any adverse effect on the functioning of the company;
- (vii) Whether any director is disqualified from being appointed as director under section 274(1)(g);
- (viii) Whether the cess payable under Section 441 A had been paid and if not details of amount of cess not so paid.

- (b) **Money raised by Public Issues:** Companies (Auditor's Report) order, 2003 requires that in case the company has made a public issue of any of its securities like shares, preference shares, debentures and other securities, the auditor is required to report upon the disclosure of end-use of the money by the management in the financial statements. The auditor is also required to state whether he has verified the disclosure made by the management in this regard.

Schedule VI to the Act requires that only unutilized amount of any public issue made by the company should be disclosed in the financial statements of a company. In the absence of any legal requirement of such disclosure, it appears that the clause envisages that the companies should disclose the end use of money raised by the public issue in the financial statements by way of notes and the auditor should verify the same.

Normally, the companies do mention the end-use of the money proposed to be raised through the public issues in the prospectus. An examination of the prospectus would provide the auditor an understanding of the proposed end-use of money raised from public. The auditor should verify that the amount of end-use of money disclosed in the financial statements by the management is not significantly different from the proposed and actual end use. The auditor should obtain a representation from the management as to the completeness of the disclosure with regard to the end-use of money raised by public issues. If the auditor is of the opinion that adequate disclosure with regard to end use of money raised by public issue has not been made in the financial statements, the auditor should state the fact in his audit report. If, for any reason, the auditor is not able to verify the end-use of money raised from public issues, he should state that he is not able to comment upon the disclosure of end-use of money by the company since he could not verify the same. He should also mention the reasons which resulted in the auditor's inability to verify the disclosure.

Question 24

As an auditor, comment on the following situation/statement:

X Ltd., to whom Companies (Auditor's Report) Order, 2003 is applicable, has issued 9% Debenture of Rs. 5 crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry Creditors and other Current Liabilities of Rs. 2.80 crores.

Answer

Application of Long-Term Funds: The Companies (Auditor's Report) Order, 2003 required the auditor to report whether funds raised on short-term basis have been used by the company for long-term investment and long-term funds have been used to finance short-term assets.

In this case, 'X' Ltd., issued 9% debentures of Rs.5 crores and out of the proceeds, it used Rs. 2.80 crores for payment of sundry creditors and other current liabilities. The auditor will enquire about the object of issue of debentures and end use of Rs.5 crores. Further, the auditor should refer to Board's resolution authorizing the utilization of the fund for payment of current liabilities. He will refer to the Cash Flow Statement and would obtain the requisite information and explanations from the management and if he is satisfied that long-term funds have been used for payment of short-term liabilities, he will state in audit report accordingly.

Question 25

Give your comments on the following:

- (a) *Mr. X, a Director of M/s KP Private Ltd., is also a Director of another company viz., M/s GP Private Ltd., which has not filed the annual accounts and annual return for last three years 2006-07 to 2008-09. Mr. X is of the opinion that he is not disqualified u/s 274(1)(g) of the Companies Act, 1956, and auditor should not mention disqualification remark in his audit report.*
- (b) *Mr. Aditya, a practising chartered accountant is appointed as a "Tax Consultant" of ABC Ltd., in which his father Mr. Singhvi is the Managing Director.*
- (c) *You have been appointed the sole auditor of a company where you were one of the joint auditors for the immediately preceding year and the said joint auditors are not re-appointed.*
- (d) *No Annual General Meeting (AGM) was held for the year ended 31st March, 2010, in XYZ Ltd., Ninu is the auditor for the previous year, whether she is continuing to hold office for current year or not.*

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Answer

- (a) **Disqualification of a Director u/s 274(1)(g) of the Companies Act, 1956:** Section 227(3)(f) of the Companies Act, 1956 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director u/s 274(1)(g) of the Companies Act, 1956. As per provisions of Section 274(1)(g), if a director is already holding a directorship of a “public company” which has not filed the annual accounts and annual returns for any continuous three financial years shall not be eligible to be appointed as a director of any other public company.

In this case since Mr X is a director of Private Ltd. Company, hence the provisions of section 274(1)(g) are not applicable to him and as such he is not disqualified from directorship of both the companies. Therefore, the auditor shall not report about the disqualification u/s 227(3)(f) of the Companies Act, 1956.

- (b) **Appointment of a Practising CA as ‘Tax Consultant’:** A chartered accountant appointed as an auditor of a company, should disclose his interest while making the audit report. If this disclosure is not made, it would amount to “misconduct” under the Chartered Accountants Act, 1949.

In this case, Mr Aditya is a “Tax Consultant” and not a “Statutory Auditor” of ABC Ltd., hence he is not liable to disclose his relationship with Managing Director of the company except as required by Section 349 of the Companies Act, 1956.

- (c) **Appointment of Sole Auditor:** When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. Accordingly, provisions of the Companies Act, 1956 to be complied with are as under:

1. Ascertain that special notice u/s 225(1) of the Companies Act, 1957 was received by the company from a member at least 14 days before the AGM date.
2. Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 190(2) of the Companies Act, 1956.
3. Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.
4. The notice is also sent to the retiring auditor as per Section 225(2) of the Companies Act, 1956.

5. Verify whether any representation, received from the retiring auditor was sent to the members of the company.
 6. Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.
- (d) **Tenure of Appointment:** Section 224(1) provides that an auditor is appointed for a particular period, i.e., from conclusion of one annual general meeting until conclusion of the next annual general meeting. In case the annual general meeting is not held within the period prescribed, the auditor will continue in office till the annual general meeting is actually held and concluded. Therefore, Ninu shall continue to hold office till the conclusion of the annual general meeting.

Question 26

As an Auditor, comment on the following situation/statement:

JKT Ltd. having Rs. 40 lacs paid up capital, Rs. 9.50 lacs reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being Rs. 4.90 crores, Rs. 4.50 crores and Rs. 6 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory.

Answer

Internal Audit System and CARO, 2003: As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies. For other companies, it is applicable if either of the following conditions is satisfied:

- a. The company has a paid-up capital and reserves exceeding Rs. 50 lakhs at the commencement of the financial year, or
- b. The company has an average annual turnover of Rs. 5 crores or more for a period of 3 years proceeding the current financial year.

In the instant case, the second condition has been fulfilled by JKT Ltd. Hence, the auditor will have to mention in his report the fact of not having such internal audit in his report by the Company.

Question 27

Write a short note on - Statutory Report of a Public Company under Section 165(4).

Answer

Audit of Statutory Report of a Public Company: Under Section 165 of the Companies Act, 1956 every public company limited by shares, or limited by guarantee and having a

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share capital, has to hold a statutory meeting of its members within a period of not less than one month and nor more than six months from the date at which the company is entitled to commence business. It sets out the following matters:

- (i) The total number of shares allotted, distinguishing shares allotted (as fully or partly paid up) otherwise than in cash, and stating in the case of shares partly paid up, the extent to which they are so paid up, and in either case, the consideration for which they have been allotted;
- (ii) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;
- (iii) An abstract of the receipts of the company and the payments made there out, up to 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, the 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;
- (iv) the names, addresses and occupations of the directors, auditors and also, manager and secretary, if any, and the changes, if any, which have occurred in such names, addresses and occupations since the date of the incorporation of the company;
- (v) the particulars of any contract which, or the modification or the proposed modification of which, is to be submitted to the meeting for its approval together in the latter case with the particulars of the modification or proposed modification;
- (vi) the extent, if any, to which each underwriting contract, if any, has not been carried out, and the reasons therefore;
- (vii) the arrears, if any, due on calls from every director and the manager; and
- (viii) the particulars of any commission or brokerage paid or to be paid for issue or sale of shares or debentures to any director or the manager.

The statutory report is to be certified as correct by at least two directors of the company, one of whom should be a managing director, where there is one. The auditors of the company should also certify that part of the report which relates to the shares allotted by the company, the cash received in respect of such shares, and the receipts and payments of the company.

Question 28

- (a) *Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.*
- (b) *PBS & Associates, a firm of Chartered Accountants, has three partners P, B and S. The firm is already having audit of 60 companies, which includes 2 branch audits of a company. The firm is offered 3 company audits, out of which one is a private company, other is a foreign company and the third one is a public company. Decide and advise whether PBS & Associates will exceed the ceiling prescribed under Section 224(1B) by accepting the above audit assignments?*

Answer

- (a) **Appointment of First Auditor of Company:** The appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 224 (5) of the Companies Act, 1956, which authorizes the Board of Directors to appoint the first auditor of the company within one month of registration of the company.

In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.

- (b) **Ceiling on number of audits:** According to Section 224 (1 B) of the Companies Act, 1956, a Chartered Accountant cannot hold more than the specified number of company audit. This section further states that in case of Chartered Accountant Firm, the specified number is 20 companies per such partner who is not in whole time employment elsewhere. Out of the above 20 companies not more than 10 companies may have a paid up share capital of Rs. 25 lakhs or more. Branch audit, special audit and foreign companies are not to be included or counted within the said specified limit as these companies are outside the scope of Section 224. As per Companies (Amendment) Act, 2000, audit of private companies are not to be counted in computation of ceiling limit.

If Mr. P, B and S do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by M/s PBS & Associates is 60. But as branch audit, audit of foreign company and private company are to be excluded while determining this figure of 60. So the firm can accept the audit of above three companies of which one is a public company as given in the question, which is well within the limit, specified by Section 224 (1 B) of the Companies Act, 1956.

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Question 29

Why Central Government permission is required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term?

Answer

Permission of Central Government for removal of auditor: Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence.

Further, in case of conflict of interest the shareholders may remove the auditors in their own interest.

Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand if auditor has completed his term i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

Question 30

As an Auditor, comment on the following:

- (a) *Company has debited Rs. 1,75,000 to Delivery Van Account received from a customer against credit sales of Rs. 1,50,000 to him who is now is not able to pay the amount. The Delivery Van has not been registered in the name of the company with R.T.O. till date of Finalisation of accounts.*
- (b) *PQ Ltd. has given donations of Rs. 50,000 each to a charitable school and a trust for blinds, during the year ended 31.3.2010. The average net Profit of the company during last three financial years amounts to Rs. 12 lacs.*
- (c) *AAS Limited had provided for doubtful debts to the extent of Rs. 23 lakhs during the year 2007-08. The amount had since been collected in the year 2009-10. Another debt of Rs. 25 lakhs had been identified to be doubtful during the year 2009-10. The Company made an additional provision of Rs. 2 lakhs during the year. The Profit and Loss account for the year ended 31.3.2010 disclosed in Debit side-provision for doubtful Debts Rs. 2 lakhs.*

- (d) *Alagar Limited is a company engaged in the business of chassis building and bus transportation services. It accounts all expenses and income in Profit and Loss account under various heads explaining clearly the nature of the operations. The auditor of the company requires that the Profit and Loss account should depict the Profit or Loss from the businesses of assembly as well as of operation of bus services separately.*

Answer

- (a) **AS 10 “Accounting For Fixed Assets”:** As per AS 10 “Accounting for Fixed Assets” When a fixed asset is acquired in exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident.

The delivery van has been acquired in exchange for another assets i.e. receivables. The fair value of delivery van is Rs 1,75,000 and that of receivable were Rs.1, 50,000. Here fair market value of the asset given up is more clearly evident. Therefore the delivery van should be valued at Rs.1, 50,000. Also the delivery van should be recognized as an asset of the company even though it is not yet registered in the name of the company. This is because legal title is not necessary for an asset to exist. What is necessary is control over the asset as per the framework for preparation and presentation of financial statements. Applying substance over form, we find since price has been settled, and the company has control of assets, hence it should be reflected as an asset along with a note to the effect that the registration in the name of the company is pending.

- (b) **Contribution To Charitable Funds:** As per the provisions of Section 293 of the Companies Act, 1956 the Board of Directors of a Public Ltd. Co., with the consent of the Company in general meeting can contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed fifty thousand rupees or five per cent of its average net profits as determined in accordance with the provisions of Sections 349 and 350 during the three financial years immediately preceding, whichever is greater.

In the given case company gave two donations of Rs.50,000 each to a charitable school and a trust for blinds i.e. Rs.1,00,000, those are not directly relating to business of the company or the welfare of its employees. According to given

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situation Board of directors can contribute either (i) Rs.50,000 or (ii) 5% of average net profit of least 3 financial years i.e. Rs. 60,000 whichever is greater.

Therefore Board of Directors can contribute maximum of Rs.60,000 to both Charitable institutions with the consent of the company in general meeting. The action of Board of directors is not correct. It has violated the provision of Section 293 of the Companies Act, and as an auditor, this matter should be reported in the auditor's report.

- (c) **Disclosure of certain ordinary activities under AS 5 :** AS per AS 5 "Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies "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.

During the relevant year, the company had collected the amount of Rs.23 lakhs for which provision had already been made earlier in the accounts. The said provision should be reversed to that extent during the relevant year. The company estimates a doubtful debt to the extent of Rs.25 lakhs in the current year which must be provided for during the relevant year. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 of AS 5 include reversals of provisions. The company had netted off the reversal and additional provision and had shown the net debit of Rs.2 lakhs in P&L account. This practice does not seem to be good as per AS 5. Company may show the net debit in P&L account but should disclose the facts of write back and additional provision made during the year by way of note. The Company's accounting treatment is wrong and it may warrant audit qualifications.

- (d) **Segmental reporting:** As per AS 17, the company accounts must be presented according to the primary classification based on nature of income and expenses and therefore segment results are to be disclosed accordingly. The result of segment should be disclosed in terms of segment revenue and segment expense.

In the instant case, the company has two business segments namely assembly and transportation. These two segments should be properly identified.

In this case, company should add note to show segment result after computation. It is not necessary that segment-wise details of each and every expenditure and revenue should be specified.

Question 31

Comment on the following:

- (a) *M/s. Seeman & Co. had been the company auditor for Amudhan Company Limited for the year 2009-10. The company had three branches located at Chennai, Delhi and Mumbai. The audits of branches-Chennai, Delhi were looked after by the company auditors themselves. The audit of Mumbai branch had been done by another auditor M/s Vasan & Co., a local auditor situated at Mumbai. The branch auditor had completed the audit and had given his report too. After this, but before finalization, the company auditor wanted to visit the Mumbai branch and have access to the inventory records maintained at the branch. The management objects to this on the grounds of the company auditor is transgressing the scope of audit areas agreed.*
- (b) *Mr. A was appointed as an auditor of X Ltd. for the year ended 31.3.2009 in the AGM held on 16.8.2008. Mr. A had indebted to the company for a sum of Rs. 2,500 as on 1.4.2008, the opening date of the accounting year which had been the subject to his audit. Upon learning that he might be appointed as the auditor, he repaid the amount on 14.8.2008. Mr. B, a shareholder complained that the appointment of Mr. A as auditor was invalid and he incurred disqualification under Section 226 of the Indian Companies Act, 1956 and his independence had been vitiated in relation to the accounting year of his audit.*
- (c) *The Financial Controller of AS Limited refuses to provide for proposed dividend in books of accounts for the year ended 31.3.2009 on the ground that it is pending approval of shareholders in Annual General Meeting to be held on 16th September 2009.*

Answer

- (a) **Right of access of company auditor for branch records:** The audit of the branch of a company is dealt with in Section 228 of the Companies Act, 1956. According to this section, the audits of the branches can be done by the company auditor himself or by another auditor. Even where, the branch accounts are audited, the company auditor has right to visit the branch if he deems it necessary to do so for the performance of his duties as auditor.

He has also right of access at all times to the books and accounts and vouchers of the company maintained at the branch office. He can appropriately deal with the report of the branch auditor in framing his main report. He will disclose how he had dealt with the branch audit report.

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In this case, the audits of two branches were done by the company auditor and one branch was done by a separate branch auditor.

Applying the above provisions, to the instant case, management's objection that the company auditor is transgressing the scope of audit areas agreed, is absolutely, wrong. The right of company auditor in visiting and accessing the records of branch can not be forfeited. Even where the branch accounts are audited by another local auditor, the company auditor has right to visit the branch and can have access to the books and vouchers of the company maintained at the branch office.

In all other cases, it will be considered as unlawful possession of the books and in such circumstances, he can not exercise such lien.

In the given case, AB & associates retains the books of accounts of Ajanta Ltd., as they have not received their audit fees. They can do so subject to the above provisions of company Law.

- (b) **Debt as disqualification for auditor:** According to Section 226 of the Companies Act, 1956, a person who is indebted to the company for an amount exceeding Rs 1,000 shall be disqualified to be an auditor of such company and he will vacate office when he incurs this qualification subsequent to his appointment.

Though not expressly said, the fact clearly tells that the relevant date for reckoning disqualification is the date of appointment viz the date of resolution passed by the company to effect such appointment.

Where the person has liquidated his debt before appointment date, there is no disqualifications to be construed for his appointment.

In the given case, Mr. A was appointed as an auditor of X Ltd. for the year ended 31-03-2009 in the AGM held on 16-08-2008. He repaid the loan amount of Rs. 2500 fully to the company on 14-08-2008 before the date of his appointment.

In view of the above provision of law, Mr. A's appointment as an auditor is valid and it is as per the provision of the above Section.

- (c) **Proposed dividend accounting:** Normally, the dividend is proposed first by Board before adoption of the accounts in AGM. It is the shareholders in AGM who may approve the dividend proposed by BOD. It is also correct that as on the date of balance sheet or subsequent to it, but before approval of the financial statements in AGM, the dividend declaration is a contingent one.

But according to AS 4, Contingencies and Events occurring after the Balance Sheet date, even though certain events occur after balance sheet date, they are included/provided in the accounts because of their special nature or statutory

requirement. Schedule VI to the Indian Companies Act, 1956 requires disclosure of proposed dividend specifically.

According to AS 4, the proposed dividend pertaining to the period covered by the financial statements, should be included in the financial statements although they are declared after the approval of the accounts.

In the circumstances, applying the above provisions, the contention of the Financial controller of AS Ltd. is wrong. Hence proposed dividend should be provided in the books of accounts for the year ended 31-03-2009, as the same is a statutory requirement of the law.

Question 32

Give your assertions for the following items appearing in balance sheet of a Limited Company:

			Rs.
(i)	Cash in hand		10,000
(ii)	Investments		1,00,000
(iii)	Secured Loans		10,00,000
(iv)	Machinery:		
	Opening cost	13,00,000	
	Less: depreciation		
	Current depreciation	1,30,000	11,70,000

Answer

(i) Cash in Hand Rs. 10,000

This is the item of current assets, exhibited on the asset side of balance sheet It implies:

- (1) that the firm concerned has Rs.10,000 in hand in valid notes and coins on the balance sheet date.
- (2) that the cash was free and available for expenditure to the firm.
- (3) that the books of accounts show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

(ii) Investments Rs.1,00,000

This is also the item to be exhibited on the asset side of balance sheet as per Schedule VI as prescribed by Company Law. This description is not giving us a complete picture of investment. We, as an auditor, must know:

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- (1) Nature of Investment, type of Investment; whether it is short term or long term investment or trade investment or non-trade investment.
- (2) Rate of interest receivable.
- (3) Face value or market value of investments as on balance sheet date.

(iii) Secured Loan Rs.10,00,000

It Implies that the company has secured loan from some parties, worth Rs. 10,00,000. The description does not give us a complete picture. We, as an auditor, must know:

- (1) the name of the lender,
- (2) the nature of security provided; and
- (3) the rate at which interest is payable.

(iv) Machinery Rs. 11,70,000.

- (1) The Company owns the Plant and Machinery whose WDV as on date of balance sheet is Rs. 11,70,000. Gross block is Rs. 13,00,000.
- (2) The Machinery physically exists.
- (3) The asset is being utilized in the business of the company productively.
- (4) Charge of depreciation on this asset is Rs.1,30,000 relates to the year in respect of which the accounts are drawn up.
- (5) The amount of depreciation, has been calculated on recognized basis and the calculation is correct.

Question 33

Comment on the following:

- (a) *During the year 2009-10, it was decided for the first time that the accounts of the branch office of AAS Company Limited be audited by qualified Chartered Accountants other than the company auditor. Accordingly, the Board had appointed branch auditors for the ensuing year. One of the shareholders complained to the Central Government that the appointments was not valid as the Board of Directors do not have power to appoint auditors, be they Company Auditor or Branch Auditors?*
- (b) *The Chief Accountant of AAS Company Limited says that the company, being in loss, would not provide depreciation for the Fixed Assets during this year, it would provide for the arrears of depreciation when it has profits in the future years; there is nothing wrong in this treatment, as according to the Companies Act, 1956, the company is*

bound to provide for depreciation only when it intends to declare dividend; in the present case, the company does not declare dividend.

- (c) *Other liabilities in Balance Sheet of AAS Limited include Rs. 7.8 lakhs being the amount of excise duty payable since 1.5.2008 remaining unpaid till 31.3.09. However, the same had been paid by the company on 15.4.2009 upon getting clarification from its advocates that the liability is actually payable by it.*

Answer

- (a) **Appointment of Branch Auditor:** Under Section 228 of the Companies Act, 1956, the accounts of the branch may be audited by the company auditor or by a separate branch auditor/s, unless where there is branch audit exemption. When it had been decided that the accounts of the branch may be audited by a person other than company auditor, the shareholders in general meeting should appoint branch auditor. The shareholders in general meeting, instead of appointing branch auditor, may authorize the board of directors to appoint branch auditors.

In the present case, the board has appointed branch auditors without obtaining authorization from the shareholders in general meeting. The board had appointed the auditor where it did not have authority to do so. As such, the appointment is invalid. The shareholder's complaint is right.

The branch auditor should ascertain before accepting the audit whether his appointment is valid.

- (b) **Non provision of depreciation:** According to Section 205 of the Companies Act, 1956, the company cannot declare dividend unless it provided for depreciation. But the true and fair view of the results of the company must be reflected in the accounts as per Section 211 of the Companies Act. Generally Accepted Accounting Principles require the depreciation to be charged for fixed assets so that the revenue matched with the cost of expiration.

The Accountant's view of looking at depreciation as a mere legal requirement for declaration of dividend is partial appreciation of the accounting reality. According to Schedule VI of the Act, the profit and loss account shall separately disclose depreciation. If no provision is made for depreciation, the same should be disclosed by way of note.

Accordingly, if the company persists in not providing the depreciation, the same should be disclosed. Again, the non-provision will be subject of qualification in the auditor's report even if it has been disclosed in notes.

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- (c) **Undisputed Statutory Liability:** According to CARO 2003, if any undisputed statutory due like excise duty, income tax etc, is not remitted within due date and is outstanding for more than six months, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In the present case, the statutory liability has crystallized and is outstanding for more than six months. It is not a disputed liability. It is an undisputed liability about which the company had some doubts.

The fact that it had been since remitted before finalization of accounts would not render the requirement of disclosure in CARO 2003 report. The fact of subsequent remittance may be added after the disclosure of non-remittance in the CARO 2003 report.

Question 34

Give your comments on the following:

- (a) *Mr. Budha, Statutory Auditors of Secret Ltd. was not permitted by the Board of Directors to attend general meeting of the company on the ground that his right to attend general meetings is restricted only to those meetings at which the accounts audited by him are to be presented and discussed.*
- (b) *M/s Young & Co., a Chartered Accountant firm, and Statutory Auditors of Old Ltd., is dissolved on 1.2.2009 due to differences of opinion among the partners. The Board of Directors of Old Ltd. in its meeting on 6.2.2009 appointed another firm M/s Sharp & Co. as their new auditors for one year.*
- (c) *Mr. Fat, auditor of Thin Ltd., has his office and residence in the building owned by Thin Ltd. Mr. Fat has been given 10% concession in rent by the company as compared to other tenants.*

Answer

- (a) According to Section 231 of the Companies Act, 1956 the auditors of a company are eligible and entitled to attend any general meeting of the company and not only those meetings at which the accounts audited by them are to be presented and discussed. However, it is not mandatory for the auditor to attend such meetings.

In the instant case, the board of directors of Secret Ltd., have no right to restrict Mr. Buddha from attending the general meeting and Mr. Buddha has every right to attend such meeting as conferred by Section 231.

Thus, the action of the board of directors is contrary to the provisions of law and curtails the right of the auditor.

- (b) Section 224(6)(a) of the Companies Act, 1956 lays down that the Board of Directors may fill any casual vacancy in the office of an auditor provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall be filled in general meeting.

The expression “casual vacancy” has not been defined in that Act. Taking its natural meaning it may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firm etc.

Furthermore Section 224(6)(b) stipulates that any auditor appointed in a casual vacancy shall hold office until the conclusion of the next AGM.

In the instant case the action of the board of directors in appointing M/s Sharp & Co. to fill up the casual vacancy due to dissolution of M/s Young & Co., is correct. However, the board of directors are not correct in giving them appointment for one year. M/s Sharp & Co. can hold office until the conclusion of next AGM only.

- (c) As per SA 200 on Basic Principles Governing an Audit in the performance of any professional service, the auditor shall maintain independence and shall not be influenced by any other consideration. In other words, at the time of expressing an opinion he should not be influenced by any consideration and shall not acquire any direct or indirect benefit or interest from the organisation which is subject to audit.

In the instant case Mr. Fat has his office and residence in the building owned by Thin Ltd. who are subject to audit by Mr. Fat. Giving 10% concession in rent may be due to some other reasons other than holding auditor ship of Thin Ltd. It may be due to being very old tenant or due to office and residence in the same building or Mr. Fat might have carried out major renovation and so on.

Thus in the instant case unless and until there is direct proof, giving 10% concession in rent does not affect independence of the auditor in expressing his opinion on the audit of Thin Ltd.

Question 35

Write short notes on the following:

- (a) *Responsibilities of Joint auditors.*
(b) *Process of Judgement formation by Auditor.*

Answer

- (a) **Responsibilities of Joint Auditors**

As per SA 299, in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him. In respect of other works, which are not divided, all the joint auditors are jointly and severally responsible for:

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- (i) Audit work which is not divided and is carried on jointly by all the joint auditors.
- (ii) Decision taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
- (iii) Matters which are brought to the notice of the joint auditors by any one of them and on which there is agreement among the joint auditors.
- (iv) Examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.
- (v) Ensuring that the audit report complies with the requirement of the relevant statute.

(b) Process of Judgement formation by auditor

After the audit, the opinion that the auditor expresses is the result of exercise of judgement on facts, evidence and circumstances which he comes across in the course of audit. The judgement is formed on the following basis:-

- (i) Identification of the assertions to be examined.
- (ii) Evaluation of the assertion as to relative importance.
- (iii) Collection of the information or evidence about the assertions to enable him to give an informed opinion.

Evaluation of evidence as valid or invalid, pertinent or not pertinent, sufficient or insufficient.

Formulation of judgement as to the fairness of the assertions under consideration.

EXERCISES

Question 1

Comment on the following:

- (a) The company had also appointed a Cost Auditor and therefore, the management had requested your firm not to review the cost records.
- (b) The management requested your firm not to comment on valuation of Inventory and realisability of certain debtors, as they had been covered in the Directors Report
- (c) While conducting the audit of a company for the year ended 31st March, 2010 the auditor called for the General Ledger for the year ended 31 March 2007 for some reference. He would not get that ledger as the books of accounts of that year were already destroyed as per the instructions of the Executive Director of the Company.
- (d) While conducting the audit of a limited company for the year ended 31st March, 2010, the auditor called for the ledger for ascertaining the details of a particular account. The ledger could not be made available to him as it was destroyed due to space constraint as per the instruction of the Executive Director of the company.

Question 2

What are the provisions of the Companies Act, 1956 with regard to the remuneration of an auditor?

Question 3

How is the Auditor's remuneration required to be disclosed in the company's Profit and Loss Account?

Question 4

"Auditor's report implies an expression of opinion by the auditor." Discuss the statement.